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**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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The accompanying financial statements of the Commonwealth of Massachusetts (Commonwealth) have been prepared in accordance with accounting principles generally accepted in the United States of America, (GAAP). The Governmental Accounting Standards Board (GASB) is the recognized standard-setting body for establishing governmental accounting and financial reporting principles. The significant Commonwealth accounting policies are described below. Except where noted, all numbers in the footnote tables and other sections of this Comprehensive Annual Financial Report are in thousands.

**A. Reporting Entity**

The Commonwealth is comprised of three branches: the Executive Branch, with the Governor as the chief executive officer; the Legislative Branch, consisting of a Senate of 40 members and a House of Representatives of 160 members; and the Judicial Branch made up of the Supreme Judicial Court, the Appeals Court and the Trial Court. In addition, the Legislature has established 56 independent authorities and agencies. Below the level of state government are 351 cities and towns exercising the functions of local governments. The cities and towns of the Commonwealth are also organized into 14 counties, but county government has been abolished in seven of those counties in recent years.

For financial reporting purposes, the Commonwealth has included all funds, organizations, account groups, agencies, boards, commissions and institutions. The Commonwealth has also considered all potential component units for which it is financially accountable as well as other organizations for which the nature and significance of their relationship with the Commonwealth is such that exclusion would cause the Commonwealth's financial statements to be misleading or incomplete. As required by GAAP, these financial statements present the Commonwealth of Massachusetts (the primary government) and its component units. The Commonwealth has included 35 entities as component units in the reporting entity because of the significance of their operational and/or financial relationships with the Commonwealth.

***Component Units and Details of Departments and Entities that are Separately Audited***

***Blended Component Units*** – Blended component units are entities that are legally separate from the Commonwealth but are so related to the Commonwealth, that they are, in substance, the same as the Commonwealth or entities providing services entirely or almost entirely to the Commonwealth. The net assets and results of operations of the following legally separate entities are presented as part of the Commonwealth's operations:

- **The Pension Reserves Investment Trust Fund (PRIT)** is the investment portfolio for the pension net assets of the Commonwealth and as such, is presented as a blended component unit. PRIT is managed by the Pension Reserves Investment Management (PRIM) Board. Certain portions related to municipal holdings of PRIT are reported as an external investment trust within the fiduciary statement of net assets and statement of changes in net assets.
- **The Health Care Security Trust Account (HCST)** is the long - term investment account of the Health Care Security Trust, a minor governmental fund. The Health Care Security Trust was the ultimate

recipient of tobacco settlement remittances to the Commonwealth from fiscal year (FY) 99 through FY02. The HCST is managed by a board of trustees, which supervises the investment and reinvestment of monies received into the HCST. The HCST utilizes certain resources and staff of PRIT or PRIM. In FY04, certain Medicaid related revenues were also managed by the HCST.

- **The Massachusetts Municipal Depository Trust (MMDT)** is an investment pool of the Commonwealth and its political subdivisions. Portions of MMDT are reported as an external investment trust within the fiduciary statement of net assets and statement of changes in net assets. MMDT is established by the Treasurer – Receiver General, who serves as trustee.

**The following entities are audited separately from the Commonwealth but are not legally separate from the Commonwealth:**

- **The Massachusetts State Lottery Commission**, a division of the Office of the State Treasurer and Receiver – General, operates the Commonwealth's lottery. The net assets of the Commission and results of operations are presented as part of the Commonwealth's governmental activities.
- **The Commonwealth of Massachusetts Owner Controlled Worker's Compensation and General Liability Insurance Program (OCIP)** provides worker's compensation and general liability insurance for all eligible contractors and subcontractors working on the Central Artery / Tunnel Project (CA / T). The OCIP is managed by the Massachusetts Highway Department.

**The institutions of higher education of the Commonwealth have operations and net assets that are presented as part of the Commonwealth's business – type activities. These systems include:**

- **The University of Massachusetts System** including its discretely presented component units, the University of Massachusetts Building Authority, the University of Massachusetts Foundation, Inc., and the Worcester City Campus Corporation (doing business as Umass Health System.) The Worcester City Campus Corporation includes a not-for-profit subsidiary, the Worcester Foundation for Biomedical Research, Inc. Finally, the University System includes the University of Massachusetts Dartmouth Foundation, Inc.
- **The State and Community College System** including the 9 State and 15 Community Colleges located throughout the Commonwealth and the Massachusetts State College Building Authority (a blended component unit). The following are Community Colleges:
  - Berkshire Community College
  - Bunker Hill Community College
  - Bristol Community College
  - Cape Cod Community College
  - Greenfield Community College
  - Holyoke Community College
  - Massasoit Community College
  - Massachusetts Bay Community College
  - Middlesex Community College
  - Mount Wachusett Community College

- Northern Essex Community College
- North Shore Community College
- Quinsigamond Community College
- Roxbury Community College
- Springfield Technical Community College

The following are State Colleges:

- Bridgewater State College
- Fitchburg State College
- Framingham State College
- Massachusetts College of Art
- Massachusetts Maritime Academy
- Massachusetts College of Liberal Arts
- Salem State College
- Westfield State College
- Worcester State College

### ***Implementation of GASB Statement 39***

In FY04, the Commonwealth implemented GASB Statement No. 39, Determining Whether Certain Organizations are Component Units, an amendment of GASB Statement No. 14, which provides additional guidance for determining whether certain organizations should be reported as component units based on the nature and significance of their relationship with the primary government and to clarify reporting requirements for those organizations. As a result, in addition to the aforementioned University of Massachusetts System component units are the following State and Community College System foundations, all of which are legally separate, tax-exempt, separately audited, component units of the various colleges. These entities resources can only be used by or are for the benefit of the various colleges to which they serve. All are presented within the various college financial statements because of the nature and significance of these entities to those colleges. Complete financial statements may be obtained at their various offices.

Community College Component Units:

- Berkshire Community College Foundation
- Bristol Community College Foundation
- Bunker Hill Community College Foundation
- Cape Cod Community College Educational Foundation, Inc.
- Greenfield Community College Foundation, Inc.
- Holyoke Community College Foundation
- Massasoit Community College Foundation
- Massachusetts Bay Community College Foundation, Inc.
- Middlesex Community College Foundation, Inc.
- The Mount Wachusett Community College Foundation, Inc.
- The Northern Essex Community College Foundation, Inc.
- North Shore Community College Foundation
- The Quinsigamond Community College Foundation, Inc.
- The Roxbury Community College Foundation, Inc.
- Springfield Technical Community College Foundation

## State College Component Units:

- Bridgewater State College Component Units:
  - The Bridgewater State College Foundation
  - The Bridgewater Alumni Association of Bridgewater State College
- Fitchburg State College Foundation, Inc.
- Framingham State College Foundation, Inc.
- Massachusetts College of Art Foundation, Inc.
- Massachusetts College of Liberal Arts Foundation, Inc.
- The Massachusetts Maritime Academy Foundation, Inc.
- Salem State College Component Units:
  - The Salem State College Foundation, Inc.
  - Salem State College Assistance Corporation
- Westfield State College Foundation, Inc.
- Worcester State Foundation

None of these foundations are considered major component units of the Commonwealth under the definitions put forth under GASB Statement 34, but are blended within their various systems.

***Other Discretely Presented Component Units that are Separately Audited*** – Discrete component units are entities which are legally separate (often called Authorities) are financially accountable to the Commonwealth, or whose relationships with the Commonwealth are such that exclusion would cause the Commonwealth's financial statements to be misleading or incomplete. The component units column of the basic financial statements includes the financial data of the following entities:

*Major Component Units:*

- **The Massachusetts Bay Transportation Authority (MBTA)** provides mass transit facilities within the Greater Boston metropolitan area, comprising 175 cities and towns.
- **The Massachusetts Turnpike Authority (MTA)** operates the Massachusetts Turnpike and the Boston Harbor Tunnel crossings that are part of the Metropolitan Highway System.
- **The Massachusetts Water Pollution Abatement Trust (MWPAT)** provides a combination of federal and Commonwealth funds for water and sewer projects around the Commonwealth as operator of the Commonwealth's State Revolving Fund.

*Minor Component Units*

- **The Massachusetts Convention Center Authority (MCCA)**
- **The Massachusetts Development Finance Agency (MassDevelopment)**
- **The Massachusetts Technology Park Corporation (MTPC)**
- **The Massachusetts Community Development Finance Corporation (MCDFC)**
- **Commonwealth Corporation**
- **The Massachusetts International Trade Council, Inc. (MITC)**
- **The Community Economic Development Assistance Corporation (CEDAC)**

- **The Massachusetts Housing Partnership (MHP)**
- **Route 3 North Transportation Improvements Association (R3N)**
- **The Commonwealth Zoological Corporation**
- **The Regional Transit Authorities (15 separate entities) including:**
  - Berkshire Regional Transit Authority
  - Brockton Area Transit Authority
  - Cape Ann Transit Authority
  - Cape Cod Regional Transit Authority
  - Franklin Regional Transit Authority
  - Greater Attleboro / Taunton Regional Authority
  - Greenfield-Montague Transportation Area
  - Lowell Regional Transit Authority
  - Martha's Vineyard Transit Authority
  - Merrimack Valley Regional Transit Authority
  - Montachusett Regional Transit Authority
  - Nantucket Regional Transit Authority
  - Pioneer Valley Regional Transit Authority
  - Southeastern Regional Transit Authority
  - Worcester Regional Transit Authority

#### *Related Organizations*

The following are “related organizations” under GASB Statement No. 14, “*The Financial Reporting Entity*” as amended by Statement 39: Massachusetts Port Authority, Massachusetts Housing Finance Agency, Massachusetts Health and Educational Facilities Authority and Massachusetts Technology Development Corporation. The Commonwealth is responsible for appointing a voting majority of the members of each entity’s board, but the Commonwealth’s accountability does not extend beyond the appointments. These entities do not meet the criteria for inclusion as component units of the Commonwealth and therefore are not part of these financial statements.

#### *Availability of Financial Statements*

The Commonwealth’s component units, departments and funds that are separately audited issue their own financial statements. These statements may be obtained by directly contacting the various entities. To obtain their phone numbers, you may contact the Office of the State Comptroller, Financial Reporting and Analysis Bureau, at (617) 973-2660.

### **B. Government – Wide Financial Statements**

The Statement of Net Assets and the Statement of Activities report information on all non-fiduciary activities of the primary government (the Commonwealth), and its component units. Primary government activities are defined as either governmental or business-type activities. Governmental activities generally are financed through taxes, intergovernmental revenues and other non-exchange revenues. Business-type activities are financed in whole or in part by fees charged to external parties for goods or services.

#### *Government – Wide Financial Statements*

The **Statement of Net Assets** presents all of the reporting entity’s non-fiduciary assets and liabilities, with the difference reported as net assets. Net assets are reported in three categories:

- **Invested in capital assets, net of related debt** consists of capital assets, net of accumulated depreciation and reduced by outstanding balances for bonds, notes and other debt that are attributed to the acquisition, construction or improvement of those assets.

- **Restricted net assets** result when constraints placed on net asset use are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through enabling legislation.
- **Unrestricted net assets** consist of net assets, which do not meet the definition of the two preceding categories.

The **Statement of Activities** demonstrates the degree to which the direct expenses of a given function or segment are offset by program revenues. Direct expenses are those that are clearly identifiable within a specific function. Program revenues include charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges that are restricted to meeting the operational or capital requirements of a particular function. Taxes and other items not meeting the definition of program revenues are instead reported as general revenue and offset or supplant the net operating deficit or surplus from governmental or business – type operations.

**C. Fund Financial Statements**

The fund financial statements present a balance sheet and a statement of revenues, expenditures and changes in fund balances for its major and aggregated non-major funds.

Separate financial statements are provided for governmental funds, proprietary funds and fiduciary funds. Major individual governmental funds and major individual proprietary funds are reported as separate columns in the fund financial statements pursuant to GASB reporting standards, with non-major funds being combined into a single column.

**D. Measurement Focus and Basis of Accounting**

The Commonwealth reports its financial position and results of operations in funds, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures/expenses. Transactions between funds within a fund type, if any, have not been eliminated.

**Governmental Activities – Government –wide financial statements** - are reported using the economic resources management focus and the full accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of cash flows. Grants and similar items are recognized as revenues as soon as all eligibility requirements imposed by the provider have been met.

**Governmental Funds – Fund Financial Statements** - account for the general governmental activities of the Commonwealth. Governmental fund statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as they become *susceptible to accrual*; generally when they are both measurable and available. Revenues are considered to be available when they are collected within the current period or soon enough thereafter to pay liabilities of the current period. Significant revenues susceptible to accrual include income, sales and use, corporation and other taxes, federal grants, federal reimbursements and other reimbursements for use of materials and services. Revenues from other financing sources are recognized when received. Expenditures are recorded in the period in which the related fund liability is incurred. Principal and interest on general long-term obligations are recorded as fund liabilities when due.



***Business – Type Activities – Government – wide financial statements*** account for activities for which a fee is charged to external users for goods or services. In these services, debt may be issued backed solely by these fees and charges. There may be also a legal requirement or a policy decision to recover costs. As such, these funds account for operations similarly to a for – profit business. The Commonwealth’s Institutions of Higher Education’s operations are reported as systems within the proprietary funds. Proprietary fund types are described in more detail below.

***Proprietary and Fiduciary Funds – Fund Financial Statements*** are presented on the same basis of accounting as the business-type activities in the government – wide financial statements.

The Commonwealth reports the following fund types:

**Governmental Fund Types:**

***General Fund***, a governmental fund, is the primary operating fund of the Commonwealth. It is used to account for all governmental transactions, except those required to be accounted for in another fund.

***Special Revenue Funds*** account for specific revenue sources that have been aggregated according to Commonwealth Finance Law to support specific governmental activities.

***Debt Service Fund*** accounts for the accumulation of resources for and the payment of debt.

***Capital Projects Funds*** account for the acquisition or construction of major Commonwealth capital facilities financed primarily from bonds and federal reimbursements.

**Proprietary Fund Types:**

***Business - Type Activities*** account for programs financed in whole or in part by fees charged to external parties for goods and services.

**Fiduciary Fund Types:**

***Pension Trust Funds*** report resources that are required to be held in trust for the members and beneficiaries of the Commonwealth’s pension plans.

***External Investment Trust Funds*** account for the portion of pooled cash and pension assets held under the custodianship of the Commonwealth for the benefit of cities, towns and other political subdivisions of the Commonwealth.

***Private Purpose Funds*** account for various gifts and bequests held by the Commonwealth of which only the income is expendable for purpose specified by the donor. The majority of the individual accounts are for perpetual cemetery care endowments on behalf of deceased individuals. The remaining trust fund in the Massachusetts School Fund, established in 1834 a fund “for the aid and encouragement of common schools.” The fund was originally capitalized from the proceeds of the 1820’s sale of the public lands upon which the State of Maine was created.

**Agency Funds** account for assets the Commonwealth holds on behalf of others. Agency Funds are custodial in nature and do not involve measurement of operations.

Within those fund types, the Commonwealth has established the following funds:

**Highway Fund**, a governmental fund, accounts for user taxes including the gas taxes and fees to finance highway maintenance and safety services.

**Lottery Funds**, governmental funds, account for the operations of the State and Arts Lotteries, which primarily finance payments for local aid.

**Debt Service Fund**, a governmental fund, accounts for the accumulation of resources, principally transfers from other funds, for the payment of long-term debt principal and interest.

**Capital Projects - Central Artery Statewide Roads and Bridges Fund**, a governmental fund, accounts for the construction of a portion of the Central Artery / Tunnel project financed from FY01 forward, as well as various other statewide road and bridge projects. These expenditures are financed from bond proceeds, certain revenues from Registry of Motor Vehicles fees (net of debt service expenditures) and payments from authorities.

**Unemployment Compensation Fund** reports the taxes collected from employers and held by the United States Treasury in the Federal Unemployment Trust Fund, from which funds are drawn for the payment of benefits to the unemployed.

**College and University Information** is presented here, aggregated by the University's activity, the State Colleges activity and the Community College's activity.

#### *Reporting Standards*

As allowed by GASB statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, the Commonwealth's proprietary funds follow all GASB pronouncements and those Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins that were issued on or before November 30, 1989, except those that conflict with a GASB pronouncement.

#### *Fiscal Year Ends*

All funds and discretely presented component units are reported using fiscal years, which end on June 30, except for the Massachusetts Turnpike Authority which utilizes a December 31 year end.

#### *Program Revenue*

Program revenue is defined by the Commonwealth to be the revenue from fees and assessments collected by departments that are directly applicable to that department's operations. A corresponding receivable is declared, if applicable.

Revenues and expenses of business type activities and proprietary funds are classified as operating or nonoperating and are subclassified by object. Operating revenues and expenses generally result from providing services and producing and delivering goods. All other revenues and expenses are reported as nonoperating.

**E. *Cash and Short-Term Investments***

The Commonwealth follows the practice of pooling the cash and cash equivalents of its Governmental and Fiduciary Funds. Cash equivalents consist of short-term investments with an original maturity of three months or less and are stated at cost. Interest earned on pooled cash is allocated to the General Fund, Expendable Trust Funds and, when so directed by law, to certain Special Revenue and Capital Projects Funds.

The Pension Trust Funds, with investments of approximately \$29,797,126,000 at fair value, are permitted to make investments in equity securities, fixed income securities, real estate, timber and other alternative investments. For investments traded in an active market, the fair value of the investment will be its market price. The Pension Trust Funds include investments in real estate, venture capital funds, real estate funds, limited partnerships, futures pools, international hedge pools, commodities pools, balanced pools, leveraged buyouts, private placements and other alternative investments. The structure, risk profile, return potential and marketability differ from traditional equity and fixed income investments. Concentration of credit risk exists if a number of companies in which the fund has invested are engaged in similar activities and have similar economic characteristics that could cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. To mitigate the exposure to concentrations of risk, the Pension Trust Funds invest in a variety of industries located in diverse geographic areas. As of June 30, 2004, the estimated fair values, determined by management with input from the investment managers, of these real estate and alternative investments were \$5,496,796,000 of the Pension Trust Funds, representing 13.4% of the total assets of the Fiduciary Fund Type.

Pension Trust Fund and External Investment Trust Fund net assets have been restricted as follows:

“Restricted for employee’s pension benefits” identifies resources held in trust for the members and beneficiaries of the Commonwealth’s pension plans.”

“Restricted for external investment trust fund participants” identifies the portion of pooled cash and pension assets held under custodianship of the Commonwealth for the benefit of cities, towns and other political subdivisions of the Commonwealth. The Commonwealth also manages pension assets on behalf of other governments.

The Commonwealth maintains a short-term investment pool. The investments are carried at amortized cost, which approximates fair value. The primary government’s and component unit’s share are reported as short-term investments within their respective reporting categories. The various local governments and other political subdivisions share of net assets is approximately \$2,005,013,000 and is reported as an External Investment Trust within the Fiduciary Fund Type.

Included in the discretely presented Component Units are investments, whose valuation was determined by management. In making its valuations, management considered the cost of investments, current and past operating results, current economic conditions and their effect on the borrowers, estimated realizable values of collateral, and other factors pertinent to the valuation of investments. There is no public market for most of the investments. Management, in making its evaluation, has in many instances relied on financial

data and on estimates by management of the companies they have invested in as to the effect of future developments.

Investments of the University of Massachusetts (UMass) are stated at fair value. Annuity contracts represent guaranteed investment contracts and are carried at present value.

**F.      *Securities Lending Program***

Under the securities lending programs, PRIT receives fees for allowing its lending agents to borrow from PRIT's public market equity and fixed income securities, respectively, for a predetermined period of time. These loans are secured with collateral (U.S. Treasury securities), typically equaling 102% of the market value of the domestic securities borrowed and 105% on borrowings of international securities. Pursuant to the Operations Support Agreements with PRIT's lending agents, Mellon Trust held all collateral for securities on loan at June 30, 2004. The collateral securities cannot be pledged or sold by PRIT unless the lending agent(s) default. The lending agents are required to indemnify PRIT in the event that they fail to return the securities on loan (and if the collateral is inadequate to replace the securities on loan) or if the lending agents fail to perform their obligations as stipulated in the agreements.

At June 30, 2004, the fair value of the securities on loan from PRIT was approximately \$2,115,720,000. The fair value of the collateral held by PRIT amounted to \$2,204,256,000 at June 30, 2004, of which \$943,000,000 was cash.

**G.      *Receivables***

In general, tax revenue is recognized on the government-wide statements, when assessed or levied and on the governmental financial statements to the extent that it is both measurable and available. Receivables are stated net of estimated allowances for uncollectible accounts.

Reimbursements due to the Commonwealth for its expenditures on federally funded reimbursement and grant programs are reported as "Federal grants and reimbursements" or "Due from federal government."

Included in receivables for FY04 are amounts due to the Commonwealth under provisions of the Master Settlement Agreement between five tobacco companies and 46 states, including the Commonwealth. Pursuant to provisions of GASB Technical Bulletin No. 2004-1 "*Tobacco Settlement Recognition and Financial Reporting Entity Issues*", a receivable has been declared for \$126.8 million, representing 50% of the amounts estimated to be received in FY05, adjusted for historical trends and included as part of a governmental fund and governmental activities within the statement of net assets.

**H.      *Due From Cities and Towns***

These amounts represent reimbursement due to the Commonwealth for its expenditures on certain programs for the benefit of cities and towns.

**I.      *Fixed Assets***

Capital assets, which include property, plant, equipment and infrastructure (e.g. roads, bridges, ramps and other similar items), are reported in the applicable governmental or business-type activity columns of the government-wide financial statements.

*Methods used to value capital assets*

Capital assets are recorded at historical cost or estimated historical cost if purchased or constructed. Donated capital assets are recorded at fair market value at the date of donation.

*Capitalization Policies*

All land, non-depreciable land improvements and donated historical treasures or works of art are capitalized, if cost is greater than \$1. Singular pieces of equipment, vehicles, computer equipment and software that equal or exceed \$50,000 (\$1,000 for the University of Massachusetts) are capitalized. Buildings and infrastructure projects with a cost that equals or exceeds \$100,000 are capitalized. The costs of normal maintenance and repairs that do not add to the value of assets or materially extend asset lives are not capitalized.

*Depreciation and useful lives*

Applicable capital assets are depreciated using the straight-line method with a full year's depreciation charged in the year of acquisition but not in the year of disposal, regardless of date. Estimated useful lives are as follows:

*Central Artery / Tunnel Project Depreciation*

In FY04, certain Central Artery / Tunnel Project segments were opened to traffic, but not transferred as of June 30, 2004 to the MTA or Massport. The

<i>Type of Asset</i>	<b>Estimated Useful Life (in years)</b>
Buildings .....	40
Infrastructure - roads, bridges and tunnels .....	40
Infrastructure - beaches, boardwalks, bikeways, etc. ....	25
Infrastructure - dams, water and sewer systems .....	50
Furniture .....	10
Library collections that are not historical treasures .....	15
Equipment, office equipment and life safety equipment .....	10
Computer hardware and software .....	3 to 7
Vehicles .....	5

Commonwealth is reporting these assets as Infrastructure – Central Artery / Tunnel Project and Land – Central Artery / Tunnel Project and has commenced depreciation on these assets. Because amounts are also reported as Due to Component Units – Central Artery / Tunnel Project and pursuant to provisions of Massachusetts statutes, the amount claimed on depreciation expense on the Central Artery / Tunnel Project is also an adjustment of the Due to Component Units – Central Artery / Tunnel Project to report the payable at net book value. These activities have no effect on the Commonwealth's statement of activities.

*Construction in Process*

Construction in process includes all associated cumulative costs of a constructed fixed asset. Construction in process is relieved at the point at which an asset is placed in service for its intended use. For the CA / T, construction in process is relieved upon agreement between the Massachusetts Highway Department, the MTA and / or the Massachusetts Port Authority, its engineers and respective boards. The chief engineer of the Highway Department, or their designees, jointly determine and certify to the MTA or the Massachusetts Port Authority that the respective authorities can safely open each such facility or segment thereof to vehicular traffic or that such facility can safely be used for its intended purpose. As of June, 30 2004, approximately \$1,736,873,000 of project costs has been transferred to the various authorities, including \$10,252,000 of costs transferred outside of the current agreements to the Massachusetts Port Authority and \$10,697,000 to the Boston Redevelopment Authority.

Fixed assets of the Component Units are capitalized upon purchase and depreciated on a straight-line basis over the estimated useful lives of the assets.

**J.      *Interfund/Intrafund  
Transactions***

As a general rule, the effect of interfund activity has been eliminated in the government-wide statements. Exceptions to this rule are: 1) activities between funds reported as governmental activities and funds reported as business-type activities and 2) activities between funds that are reported in different functional categories in either the governmental or business-type activities column. Elimination of these activities would distort the direct costs and program revenues for the functions concerned. Interfund receivables and payables have been eliminated from the Statement of Net Assets, except for the residual amounts due between governmental and business-type activities.

**K.      *Statewide Cost  
Allocation Plan –  
Fringe Benefit Cost  
Recovery***

The Commonwealth has elected not to present its cost allocation and recovery separately on the statement of activities. Certain costs of nine “central service” agencies of the Commonwealth are recovered from the remaining agencies in a federally approved statewide cost allocation plan. These costs that are allocated are based upon benefits received by the user agency that benefits from these services. The Commonwealth also appropriates and pays the fringe benefit costs of its employees and retirees through the General Fund. These fringe benefits include the costs of employees’ group health insurance, pensions, unemployment compensation and other costs necessary to support the workforce. As directed by Massachusetts General Laws, these costs are assessed to other funds based on payroll costs, net of credits for direct payments. Since fringe benefit costs are not separately appropriated or otherwise provided for in these funds, the required assessment creates an unfavorable budget variance in the budgeted funds. The employees’ group health insurance and worker’s compensation activity is accounted for in the governmental funds.

**L.      *School Construction  
Grants and Contract  
Assistance Payable***

The Commonwealth, through legislation, is committed to reimburse certain cities, towns and regional school districts for a portion of their debt service costs for school construction and renovation. This amount is recorded as a long-term liability in the statement of net assets. The liability for school construction grants payable is the present value of the cash flows due to municipalities for the life of the program for existing commitments, discounted at the incremental borrowing rate of the Commonwealth, approximated by the Treasurer and Receiver – General for the fiscal year.

Subsequent to June 30, 2004, the Commonwealth passed legislation creating a separate authority to assume these liabilities. The legislation also authorizes \$1 billion in bonding authority for the Commonwealth to capitalize the authority. The authority will be the recipient of dedicated sales tax revenues commencing in FY05 totaling \$395,700,000 and escalating in the future. The authority will also have bonding authority of its own, to a maximum of \$10 billion, to be repaid from these dedicated sales tax revenues.

The Commonwealth recognizes contract assistance due to MCCA, R3N, MWPAT and MassDevelopment as long-term liabilities on the statement of net assets. These liabilities equate to portions or the whole of certain debt service of these entities. In addition, a payable is declared to the MTA as a cash flow reimbursement for the operations and maintenance of the Central Artery / Tunnel Project.

**M.      *Compensated  
Absences***

Compensated absences are recorded as a long-term liability in the statement of net assets. Amounts to be paid during the next fiscal year are reported as current.

For the governmental fund statements, accumulated vacation and sick leave expected to be liquidated with expendable available financial resources, defined as tax revenues earned but received during the next fiscal year, are reported as expenditures and fund liabilities.

Employees are granted vacation and sick leave in varying amounts based on collective bargaining agreements and state laws. Upon retirement, termination or death, certain employees are compensated for unused vacation and sick leave (subject to certain limitations) at their current rate of pay.

In the business type activity and the discretely presented component units, employees' accumulated vacation and sick leave are recorded as an expense and liability as the benefits accrue.

**N. Long Term Obligations**

Long-term obligations consist of unmatured long term debt obligations, CA/T assets due to discretely presented component units and related organizations, school construction grants and contract assistance payable to component units and other liabilities including capital lease obligations and the net pension obligation of the Commonwealth (representing the actuarially derived pension cost in excess of actual contributions made).

**O. Lottery Revenue and Prizes**

Ticket revenues and prizes awarded by the Massachusetts Lottery Commission are recognized as drawings are held. For certain prizes payable in installments, the Commonwealth purchases annuities and principal-only and interest-only treasury strips in the Commonwealth's name, which are recorded as annuity contracts and prizes payable in Agency Funds. Though the annuities are in the Commonwealth's name in the case of a default, they are solely for the benefit of the prizewinner. The Commonwealth retains the risk related to such annuities.

**P. Risk Financing**

The Commonwealth does not insure for employees workers' compensation, casualty, theft, tort claims and other losses. Such losses, including estimates of amounts incurred but not reported, are included as accrued liabilities in the accompanying financial statements when the loss is incurred. For employee's workers' compensation, the Commonwealth assumes the full risk of claims filed under a program managed by the Human Resources Division. For personal injury or property damages, Massachusetts General Laws limit the risk assumed by the Commonwealth to \$100,000 per occurrence, in most circumstances. The Group Insurance Commission administers health care and other insurance for the Commonwealth's employees and retirees.

**Q. Net Assets**

The Commonwealth reports net assets as reserved where legally segregated for a specific future use. Otherwise, these balances are considered unrestricted.

Net Assets have been restricted as follows:

"Restricted for Capital Projects" – identifies amounts of unspent proceeds of capital bond issuances.

"Restricted for unemployment benefits" – identifies amounts solely for payment of unemployment compensation.

"Restricted for retirement of indebtedness" – identifies amounts held by fiscal agents to fund future debt service obligations pertaining to Special Obligation Revenue Bonds authorized under Section 20 of Chapter 29 of the Massachusetts General Laws and Chapter 33, Acts of 1991. It also includes amounts held for Grant Anticipation Notes authorized by Chapter 11 of the Acts of 1997 and Chapter 121 of the Acts of 1998. Escrows related to crossover refundings are also restricted.

“Restricted for central artery workers’ compensation and general liability” – identifies amounts held to pay future workers’ compensation and general liability claims through the Central Artery / Tunnel Project’s owner controlled insurance program.

“Restricted for other purposes” – identifies amounts held for various externally imposed restrictions either by creditors, grantors or laws and regulations of other governments. It also includes various restrictions put forth by the Commonwealth through constitutional or enabling statutes. Included in this restriction are reserves for stabilization and prior appropriations continued.

**R.      *Reclassifications and  
Restatement***

Certain amounts in the separately issued Component Units financial statements have been reclassified to conform to the accounting classifications used by the Commonwealth. Due to the provisions of GASB Statement No. 34 (“GASB 34”) “*Basic Financial Statements – and Management’s Discussion and Analysis – For State and Local Governments*”, major governmental and proprietary funds presented in a previous year may not be major funds presented in the current year.

For FY04, the Commonwealth implemented Statement No. 39, “*Determining Whether Certain Organizations Are Component Units*” amends Statement No. 14, “*The Financial Reporting Entity*.” Due to the provisions of Statement 39, the beginning balance of the State Colleges System and the Community Colleges System, both proprietary funds, were restated to include activity related to their foundations, which are reflected as component units. No prior period activity is available. The University of Massachusetts has previously included their foundations as part of the reporting entity. The effect on the beginning balance for the State Colleges System was approximately \$57,664,000 and the Community Colleges System was approximately \$43,483,000.

**S.      *New Accounting  
Standards***

During FY04, the Commonwealth implemented the following new accounting standards issued by the GASB:

Technical Bulletin No. 2004 – 1 “*Tobacco Settlement Recognition and Financial Reporting Entity Issues*”. This Bulletin clarifies revenue recognition and receivables disclosure with regard to the Master Settlement Agreement with the tobacco industry. The Commonwealth recorded revenue and a receivable for approximately \$126,766,000.

Statement No. 39 “*Determining Whether Certain Organizations Are Component Units*” amends Statement No. 14, “*The Financial Reporting Entity*.”

For FY05, the Commonwealth will be implementing the following:

Statement No. 40 “*Deposit and Investment Risk Disclosures*,” amends Statement No. 3 “*Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*”.

For FY06, the Commonwealth will be implementing the following:

Statement No. 42 “*Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*”.

Statement No. 44 “*Economic Condition Reporting: The Statistical Section, an amendment of NCGA Statement 1*”. As of the date of the opinion, the Commonwealth has not evaluated the financial impact of GASB Statements 40 or 42. Statement 44 has no financial impact.



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## 2. BUDGETARY CONTROL

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State finance law requires that a balanced budget be approved by the Governor and the Legislature. The Governor presents an annual budget to the Legislature, which includes estimates of revenues and other financing sources and recommended expenditures and other financing uses. The Legislature, which has full authority to amend the budget, adopts an expenditure budget by appropriating monies at the individual appropriation account level in an annual appropriations act.

Before signing the appropriations act, the Governor may veto or reduce any specific item, subject to legislative override. Further changes to the budget established in the annual appropriations act may be made via supplemental appropriation acts or other legislative acts. These must also be signed by the Governor and are subject to the line item veto.

In addition, Massachusetts General Laws authorize the Secretary of Administration and Finance, with the approval of the Governor, upon determination that available revenues will be insufficient to meet authorized expenditures, to withhold allotments of appropriated funds which effectively reduce the account's expenditure budget.

The majority of the Commonwealth's appropriations are non-continuing accounts which lapse at the end of each fiscal year. Others are continuing accounts for which the Legislature has authorized that an unspent balance from the prior year be carried forward and made available for spending in the current fiscal year. In addition, the Legislature may direct that certain revenues be retained and made available for spending within an appropriation. Fringe benefits and other costs which are mandated by state finance law are not itemized in the appropriation process and are not separately budgeted.

Because revenue budgets are not updated subsequent to the original appropriation act, the comparison of the initial revenue budget to the subsequent, and often modified, expenditure budget can be misleading. Also, these financial statements portray fund accounting with gross inflows and outflows, thus creating a discrepancy to separately published budget documents. In conducting the budget process, the Commonwealth excludes those interfund transactions that by their nature have no impact on the combined fund balance of the budgeted funds.

Generally, expenditures may not exceed the level of spending authorized for an appropriation account. However, the Commonwealth is statutorily required to pay debt service, regardless of whether such amounts are appropriated.

The FY04 General Appropriation Act (Chapter 26, Section 167 of the Acts of 2003), amended section 9C, directing the Governor to notify the Legislature in writing as to the reasons for and the effect of any reductions. Alternatively, the Governor may propose specific additional revenues to equal the deficiency. The Governor may also propose to transfer funds from the Stabilization Fund to cure such deficiency. This proposal must be delivered to the Legislature 15 days before any reductions take effect.

The following table summarizes budgetary activity for FY04 (amounts in thousands):

	<u>Revenues</u>	<u>Expenditures</u>
General Appropriation Act, Chapter 26 of the Acts of 2003:		
Direct appropriations.....	\$ 20,811,293	\$ 20,685,549
Estimated revenues, transfers, direct appropriations retained revenue appropriations, interagency chargebacks and appropriations carried forward from FY2003 .....	1,192,798	1,192,798
Total original budget.....	22,004,092	21,878,347
Supplemental Acts of 2003:		
Chapter 101.....	-	1,619
Chapter 118.....	-	22,161
Chapter 140.....	-	110,393
Chapter 141.....	-	20,750
Supplemental Acts of 2004:		
Chapter 40.....	-	52,188
Chapter 65.....	-	64,076
Chapter 304.....	-	11,529
Total before June 30, 2004 .....	22,004,092	22,161,063
Supplemental Acts of 2004, passed after June 30, but for FY04:		
Chapter 352 .....	-	389,133
Total budgeted revenues and expenditures per legislative action .....	22,004,092	22,550,196
Plus: transfers of revenues and expenditures (including rounding).....	511,643	1,905,490
Budgeted revenues and expenditures as reported.....	<u>\$ 22,515,735</u>	<u>\$ 24,455,686</u>

The Commonwealth's FY04 Statutory Basis Financial Report (SBFR) demonstrates budgetary compliance on a statutory basis. This report is separately available at <http://www.mass.gov/osc/reports/reports.htm>.

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### 3. DEPOSITS AND INVESTMENTS

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#### *Primary Government -*

As of June 30, 2004, the carrying amount of the Primary Government's total cash and cash equivalents was approximately \$6,286,069,000 and the corresponding bank balance was approximately \$6,408,518,000. Bank deposits in the amount of approximately \$174,958,000 were insured by the Federal Deposit Insurance Corporation. Deposits of approximately \$6,408,343,000 were uninsured and uncollateralized.

#### *Component Units -*

As of June 30, 2004, the carrying amount of the discretely presented component units' total cash and cash equivalents was approximately \$1,046,802,000 and the corresponding bank balances were approximately \$877,578,000. Bank deposits of approximately \$155,521,000 were insured by the Federal Deposit Insurance Corporation, approximately \$37,135,000 were collateralized in the name of the respective component units, and approximately \$684,922,000 were uninsured and uncollateralized.

**Investments** – The investments are reported at fair value in the financial statements. The deposits and investments of the Component Units and the University and College Funds and the investments of the Pension Trust Funds are held separately from those of other Commonwealth funds, with the exception of their investments in MMDT. Statutes authorize the Primary Government to invest in obligations of the U.S. Treasury, authorized bonds of all states, bankers' acceptances, certificates of deposit, commercial paper rated within the three highest classifications established by Standard & Poor's Corporation and Moody's Commercial Paper Record and repurchase agreements secured by any of these obligations. The Pension Trust Funds are permitted to make investments in equity securities, fixed income securities, real estate and other alternative investments. In the following table, these alternative investments, venture capital and futures pools are classified as other investments.

Short-term investments and investments are classified as to collateral risk into the following three categories:

Category 1: Insured or registered, or securities held by the Commonwealth or its agent in the Commonwealth's name.

Category 2: Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the Commonwealth's name.

Category 3: Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the Commonwealth's name.

**Primary Government** – Investments of the Government at June 30, 2004, were as follows (amounts in thousands):

Investment	CATEGORY 1	CATEGORY 2	CATEGORY 3	Total
Repurchase agreements.....	\$ -	\$ -	\$ 158,758	\$ 158,758
Government obligations.....	3,024,201	148,212	-	3,172,413
Commercial paper.....	3,998,002	-	-	3,998,002
Equity securities.....	16,965,785	1,410	11,397	16,978,592
Fixed income securities.....	5,081,206	6,081	12,657	5,099,944
Other.....	19,328	3,707	2,222	25,257
	<u>\$ 29,088,522</u>	<u>\$ 159,410</u>	<u>\$ 185,034</u>	29,432,966
Money market investments.....				2,747,238
Mutual fund investments and annuity contracts.....				1,519,242
Real estate.....				2,790,627
Assets held in trust.....				3,043,993
Certificates of deposit.....				859,225
Other, including carrying amount of cash and cash equivalents.....				6,134,301
Total cash and investments.....				<u>\$ 46,527,592</u>

**A. Financial Investments  
with Off-Balance Sheet  
Risk**

Certain investments of the Commonwealth may involve a degree of risk not accounted for on the respective financial statements. A description of such “off-balance sheet risks” is as follows.

*Foreign Currency Exchange Contracts*

Within the Pension Trust Funds, PRIT enters into forward currency contracts to hedge the exposure to changes in foreign currency exchange rates on foreign portfolio holdings. The market value of the contract will fluctuate with changes in currency exchange rates.

The contract is marked-to-market daily and the change in market value is recorded by the fund as an unrealized gain or loss by the Pension Trust Fund.

When the contract is closed, the Pension Trust Funds record a realized gain or loss equal to the difference between the value of the contract at the time it was opened and the value at the time it was closed. The maximum potential loss from such contract is the aggregate face value in U.S. dollars at the time the contract was opened.

As of June 30, 2004, PRIT had open foreign exchange contracts with combined net unrealized losses of \$7,348,000 with various delivery dates to November 2004.

*Futures Contracts*

Within the Pension Trust Funds, PRIT may purchase and sell financial futures contracts to hedge against changes in the values of securities the fund owes or expects to purchase. Upon entering such contracts, they must pledge to the broker an amount of cash or securities equal to the minimum “initial margin” requirements of the futures.

The potential risk is that the change in the value of futures contracts primarily corresponds with the value of underlying instruments, which may not correspond to the change in value of the hedged instruments. In addition, there is a risk that PRIT may not be able to close out its futures positions due to a nonliquid secondary market. Risks may arise from the potential inability of a counterparty to meet the terms of a contract and from unanticipated movements in the value of a foreign currency relative to the U.S. dollar. The Pension Trust Funds may also invest in financial futures contracts for nonhedging purposes.

Payments are made or received by the Pension Trust Funds each day, depending on the daily fluctuations in the value of the underlying security, and are recorded as unrealized gains or losses. When the contracts are closed, the Pension Trust Funds recognize a gain or loss.

As of June 30, 2004, outstanding futures contracts held by PRIT had an aggregate unrealized appreciation of \$15,345,000 with expiration dates ranging to December 2005.

#### *Forward Purchase Agreement*

During FY02, the Commonwealth entered into a forward purchase agreement with two investment providers to receive investment earnings on grant draws for the payment of the Commonwealth's Grant Anticipation Notes (GANs) principal and interest for the period from June 19, 2002 to July 15, 2014 for note payments approximately six to eleven months after these grant draws. The agreements may only be terminated in the event of a defeasance or refunding of the GANs by the Commonwealth. Should termination occur, the Commonwealth may be liable for a termination amount to be agreed upon between the Commonwealth and the providers at the termination date.

#### *Options*

PRIT is also engaged in selling or "writing" options. The Pension Trust Funds, as writers of options, may have no control over whether the underlying securities may be sold (call) or purchased (put) and, as a result, bear the market risk of an unfavorable change in the price of the security underlying the written option. As of June 30, 2004, there were no material options outstanding.

#### *Swap Agreements at PRIT and HST*

During FY04, PRIT's Core Realty Holdings LLC (a limited liability company inclusive of PRIT and HST – "LLC,") entered into eight interest rate swap contracts for the purpose of hedging its floating – rate interest exposure. PRIT holds 99.43% of the LLC while HST holds the remaining 0.57%. The swap contracts are reported at fair value, which represents their estimated liquidation values (costs) to the LLC. The LLC either receives cash from the swap counterparties or pays the swap counterparties monthly depending on whether the fixed-rate interest is lower or higher than the variable – rate interest. Changes in the fair value of the swap contracts are included in net change in unrealized appreciation on investments and foreign currency transactions, and the income or expense related to settlements of interest under the contracts are included in real estate income, net in PRIT and HST's financial statements.

As of June 30, 2004, the LLC had the following swap contracts in effect (amounts in thousands):

Counterparty	Fixed Rate Paid	Notional Amount	Effective Date	Maturity Date	Fair-Value
Fleet National Bank.....	4.82%	\$ 50,000,000	07/23/02	07/01/12	\$ (1,254,090)
Citibank, N. A. New York.....	4.32%	50,000,000	08/05/02	08/01/06	(937,978)
Bear Stearns Bank PLC.....	3.95%	50,000,000	08/19/02	09/01/07	(947,773)
Fleet National Bank.....	4.18%	50,000,000	12/02/02	12/03/12	1,202,068
Citibank, N. A. New York.....	3.68%	50,000,000	01/01/03	01/01/10	896,039
Mellon Bank.....	3.17%	50,000,000	01/30/03	02/01/08	578,970
Mellon Bank.....	3.82%	50,000,000	03/06/03	06/01/13	2,813,756
Bear Stearns Bank PLC.....	3.45%	50,000,000	05/13/03	06/01/11	2,626,932
Citibank, N. A. New York.....	3.54%	50,000,000	08/21/03	09/01/08	287,507
Fleet National Bank.....	4.34%	50,000,000	09/22/03	12/01/13	1,138,128
Citibank, N. A. New York.....	4.11%	50,000,000	10/27/03	12/01/11	870,400
Bear Stearns Bank PLC.....	3.37%	50,000,000	11/24/03	03/01/09	1,013,917
Fleet National Bank.....	4.32%	50,000,000	12/17/03	06/01/14	1,470,340
Citibank, N. A. New York.....	3.98%	50,000,000	04/23/04	06/01/10	374,807
Bear Stearns Bank PLC.....	5.01%	50,000,000	05/21/04	12/01/14	(1,223,693)
Mellon Bank.....	4.49%	<u>50,000,000</u>	06/21/04	12/01/10	<u>(710,605)</u>
		<u>\$ 800,000,000</u>			<u>\$ 8,198,725</u>

To determine the fair values of its swap agreements, the LLC uses methods and assumptions considering market conditions and risks existing at the date of PRIT's financial statements. Such methods and assumptions incorporate standard valuation conventions and techniques such as discounted cash flow analysis and option pricing models. All methods utilized to estimate fair values result in only general approximations of value, and such values may or may not actually be realized. Fair value estimates are closely correlated with changes in market interest rates and the passage of time. For example, rising market interest rates will generally increase the swaps' termination values to the LLC, whereas termination values are generally reduced as the swaps approach their maturity dates and fewer interest settlements remain under the contracts. As of June 30, 2004, neither the LLC, nor its counterparties expressed intentions to terminate its swap agreements prior to their scheduled maturity dates.

**B. Discretely Presented  
Component Unit  
Investments**

Investments of the discretely presented component units at June 30, 2004 are as follows (amounts in thousands):

	Category 1	Category 2	Category 3	Total
<b>Investment</b>				
Repurchase agreements.....	\$ -	\$ 444,380	\$ 2,632	\$ 447,012
U.S. Treasury obligations.....	17,269	-	-	17,269
Commercial paper.....	66,284	-	-	66,284
Government obligations.....	660,990	117,835	2,100	780,925
Equity securities.....	17,114	161,060	-	178,174
Fixed income securities.....	<u>47,782</u>	<u>97,531</u>	<u>-</u>	<u>145,313</u>
	<u>\$ 809,439</u>	<u>\$ 820,806</u>	<u>\$ 4,732</u>	1,634,977
Money market investments.....				62,152
Mutual fund investments.....				311,998
Guaranteed investment contracts.....				1,190,080
Negotiable certificate of deposits.....				23,256
Other, including carrying amount of cash and cash equivalents.....				<u>1,064,715</u>
Total cash and investments.....				<u>\$ 4,287,178</u>

*Component Unit Swap Agreement Investments*

In FY99, the MTA entered into an interest rate swap option agreement with Morgan Guaranty Trust Company of New York (MGTC). This “Swaption” agreement runs through July 1, 2029 and carries a notional amount of \$100 million. The MTA received a premium payment in FY00 of \$5.4 million as part of the agreement. This premium was recorded by the MBTA as a deferred credit and is being recongnized as an adjustment of interest expense over the 30-year life of the agreement. MGTC had the right, but not the obligation, to exercise the swap option on January 1, April 1, July 1 and October 1 of any year from July 1, 2002 to July 1, 2029. MGTC had the right to enter the MTA into the swap when the average Bond Market Association Municipal Swap Index (BMA) / London Interbank Offered Rate (LIBOR) ratio exceeds 72% over 12 consecutive months beginning April 1, 2002. The MTA’s payment obligation would be equal to the difference between the BMA and 67% of LIBOR, multiplied by the \$100 million. Conversely, the Authority may receive payments under this agreement when 67% of LIBOR exceeds the BMA. MGTC exercised its option on October 1, 2002. The MTA received \$194,000 of interest in January 2004. The MTA may be exposed to certain risks related to this transaction should the counterparty default.

The MBTA has also entered into various agreements in order to provide the MBTA with a stable and predictable cost of fuel. These agreements create a synthetic fixed rate for the purchase of fuel for fixed periods of time rather than being exposed to unpredictable variations of fuel prices on the spot market. Prices are sourced through PLATT’s Oilgram Price Report. The hedge agreements are summarized as follows (amount in thousands):

Commodity Type	Price Per Gallon	Initial Notional Amount Gallons	Trade Date	Termination Date	Counterparty (ratings - Moody's / S&P)
Bus Fuel - Jet Fuel.....	\$0.7925	3,945	9/12/2003	6/30/2004	Aal / AA
Rail Fuel - Heating Oil.....	\$0.7500	6,318	9/12/2003	6/30/2004	Aal / AA

The MBTA is exposed to basis risk on its fuel swaps, where the fuel price index used on the swaps may not fully offset the actual cost of the MBTA’s fuel purchases.

The MBTA also has an “asset-side” swaption for a reserve investment. This swaption was executed in FY01 and has a notional amount of \$49,123,000. The MBTA received a lump – sum payment on the swaption of \$1,265,000 in FY02. The counterparty may execute its option annually on January 1 and July 1 from 2010 through 2030. The agreement has a fixed payable rate of 5.6% and a variable receivable rate at BMA. The counterparty has a Aa2 / Aa+ credit rating as of June 30, 2004. The agreement’s fair value as of June 30, 2004 was (\$2,194,000).

In FY01, the MTA entered into five interest rate swap options with UBS AG, the Parent Company of UBSPaine Webber (UBS). These swaptions grant UBS the right to enter a swap with the MTA in which UBS would pay a floating rate and receive a fixed rate from the MTA. The swaption exercise dates and fixed rates due from the MTA are designed to match the call provisions and rates of certain of the MTA’s bonds. If UBS exercises its option, the MTA expects to

refund certain of its fixed rate bonds with floating rate bonds. The floating rate received by the MBTA under the swap would provide a hedge for the floating rate due on its refunding bonds. In turn, the MTA's payments to UBS would match the payments expected to be made to fixed rate bondholders. UBS paid \$6.2 million on behalf of the MTA during FY01 to purchase insurance for the payments that the MTA may be required to make under the swaps, if exercised. This amount was recorded in the MTA's financial statements as prepaid insurance and is amortized over the life of the swap, which is 35 years.

As of December 31, 2003 the Authority had recorded a long-term receivable of \$16.4 million related to the swaption. A corresponding deferred credit totaling \$27.5 million was recorded during FY04 related to this transaction. This amount is being amortized over the life of the swap, which is 35 years. The balance at December 31, 2002 was \$28.3 million. The MTA may be exposed to certain risks related to this transaction should the counterparty default.

In FY03, the MTA entered into five interest rate swap option agreements with Lehman Brothers Special Financing Inc. (Lehman). These Swaptions grant Lehman the right to enter a swap with the MTA in which Lehman would pay the MTA a fixed rate of 5% and the MTA would pay Lehman a floating rate of BMA. As a fixed – to – floating swap, the transaction was designed to “offset” the FY01 UBS swaption and, as a result, has the effect of mitigating certain risks inherent in that transaction if both are executed. Lehman paid \$6.4 million to the MTA during FY03 and will pay an additional \$28.8 million in subsequent years. This amount was recorded in the MTA's financial statements as a deferred credit and will be amortized over the life of the swap, which is 35 years.

A corresponding deferred credit totaling \$35.2 million was recorded during FY03 related to this transaction. This amount is being amortized over the life of the swap, which is 35 years. The MTA may be exposed to certain risks related to this transaction should the counterparty default. The unamortized balance as of December 31, 2003 is \$34.2 million.

In order to mitigate potential future market risks associated with the UBS and Lehman swaption agreements, the MTA set aside \$12.5 million in cash and investments in FY02.

Receivable amounts recorded by the MTA under these agreements are as follows (amount in thousands):

Due January 1,	UBS Amounts	Lehman Amounts
2004.....	\$ 3,281	\$ 5,849
2005.....	3,281	5,849
2006.....	3,281	5,849
2007.....	3,281	5,849
2008.....	3,281	-
	16,405	23,396
Less: Current Portion.....	(3,281)	(5,849)
	<u>\$ 13,124</u>	<u>\$ 17,547</u>



**4. RECEIVABLES**

Taxes, federal reimbursements, loans and other receivables are presented in the statement of net assets as follows (amounts in thousands):

<i>Primary Government</i>	Taxes Receivable	Federal Grants and Reimbursements	Loans	Other Receivables	Total
Governmental receivables .....	\$ 2,402,981	\$ 1,598,341	\$ -	\$ 1,435,044	\$ 5,436,366
Business-type activity receivables.....	-	43,864	61,497	775,031	880,392
Less: allowance for uncollectibles.....	<u>(284,643)</u>	<u>(5,683)</u>	<u>(6,324)</u>	<u>(1,279,415)</u>	<u>(1,576,065)</u>
Receivables, net of allowance for uncollectibles .....	2,118,338	1,636,522	55,173	930,660	4,740,693
Less: current portion:					
Governmental activities .....	(2,118,338)	(1,592,658)	-	(348,302)	(4,059,298)
Business-type activities .....	<u>-</u>	<u>(43,864)</u>	<u>(39,170)</u>	<u>(550,204)</u>	<u>(633,238)</u>
Noncurrent receivables .....	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 16,003</u>	<u>\$ 32,154</u>	<u>\$ 48,157</u>

  

<i>Discretely Presented Component Units</i>	Taxes Receivable	Federal Grants and Reimbursements	Loans	Other Receivables	Total
Massachusetts Bay Transportation Authority .....	\$ -	\$ 19,243	\$ -	\$ 17,771	\$ 37,014
Massachusetts Turnpike Authority.....	-	-	-	55,244	55,244
Massachusetts Water Pollution Abatement Trust .....	-	15,243	2,309,863	60,305	2,385,411
Nonmajor component units .....	-	20,214	269,947	56,550	346,711
Less: allowance for uncollectibles.....	-	-	(12,544)	(3,235)	(15,779)
Receivables, net of allowance for uncollectibles .....	-	54,700	2,567,266	186,635	2,808,601
Less: current portion .....	-	(54,700)	(145,517)	(142,848)	(343,065)
Noncurrent receivables .....	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,421,749</u>	<u>\$ 43,787</u>	<u>\$ 2,465,536</u>

## 5. RECEIVABLES, PAYABLES AND TRANSFERS BETWEEN FUNDS

Activity between funds reflected as due to / from primary government in the combined balance sheet and various transfers in the combined statement of revenues, expenditures and changes in fund balance as of June 30, 2004 are summarized as follows (amounts in thousands):

		<b>Transfers to Other Funds</b>						
<b>Governmental Funds</b>								
<b>Transfers from Other Funds:</b>	General	Highway	Debt Service*	Lotteries	Central Artery Statewide Roads and Bridges	Other Governmental Funds	Total Governmental Funds	
General.....	\$ -	\$ 200	\$ -	\$ -	\$ -	\$ 581,753	\$ 581,953	
Highway.....	45,181	-	-	-	73,808	6,172	125,161	
Lotteries.....	985,236	-	-	-	-	-	985,236	
Debt Service*.....	759,026	733,207	-	-	-	15,301	1,507,534	
Central Artery Statewide Roads and Bridges.....	-	-	-	-	-	89	89	
Other governmental funds.....	783,787	68,798	-	-	-	1,414,873	2,267,458	
<b>Total Governmental Funds.....</b>	<b>2,573,230</b>	<b>802,205</b>	<b>-</b>	<b>-</b>	<b>73,808</b>	<b>2,018,188</b>	<b>5,467,431</b>	
University of Massachusetts.....	37,457	-	-	-	-	-	37,457	
State Colleges.....	11,226	-	-	-	-	-	11,226	
Community Colleges.....	14,550	-	-	-	-	-	14,550	
<b>Total Transfers.....</b>	<b>\$ 2,636,463</b>	<b>\$ 802,205</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 73,808</b>	<b>\$ 2,018,188</b>	<b>\$ 5,530,664</b>	

\*Transfers for debt service are net of amounts funded in escrows for crossover refunding debt.

The following is a summary of receivables and payables between funds remaining as of June 30, 2004 (amounts in thousands):

	<u>Due From Other Funds</u>					
				Central Artery Statewide	Other Governmental	Total Governmental
<u>Due to Other Funds:</u>	<u>General</u>	<u>Highway</u>	<u>Lotteries</u>	<u>Roads and Bridges</u>	<u>Funds</u>	<u>Funds</u>
General.....	\$ -	\$ -	\$ -	\$ 691,992	\$ 100,882	\$ 792,874
Highway.....	710,594	-	-	-	-	710,594
Other governmental funds.....	<u>756,525</u>	<u>47</u>	<u>-</u>	<u>-</u>	<u>378,298</u>	<u>1,134,870</u>
<b>Total Governmental Funds.....</b>	1,467,119	47	-	691,992	479,180	<b>2,638,338</b>
University of Massachusetts.....	<u>9,959</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>9,959</u>
<b>Total amounts due.....</b>	<b>\$ 1,477,078</b>	<b>\$ 47</b>	<b>\$ -</b>	<b>\$ 691,992</b>	<b>\$ 479,180</b>	<b>\$ 2,648,297</b>

#### *Central Artery / Tunnel Project*

The Commonwealth is currently engaged in the most expensive public construction project in the history of the United States, the Central Artery / Tunnel Project (CA/T or Project). The project will depress the Central Artery (Interstate 93) through downtown Boston and connect the Massachusetts Turnpike (Interstate 90) through a tunnel under Boston Harbor directly to Logan International Airport. In addition to Commonwealth debt and funds from the Federal Government, the MTA (a component unit) and Massport (a related organization) have contributed to the costs of construction. Other assets have transferred to the city of Boston. Once completed, the assets of the project will be transferred to these entities for operations and maintenance.

The Commonwealth has recorded the Commonwealth's construction cost to date for the Central Artery / Tunnel Project, net of amounts transferred to the MTA and Massport. This amount is reflected as "Construction in Process – Central Artery / Tunnel Project". This amount is offset by two corresponding liabilities: "Due to Component Units – Central Artery / Tunnel Project" in the Statement of Net Assets for the MTA's portion and "Due to Other Related Organizations" for Massport's portion. As portions of the project are completed and transferred to either the MTA or Massport in accordance with Massachusetts General Laws, Chapter 81A, these amounts will be reduced for the value of the assets transferred.

The MTA presents its audited financial statements on a calendar year basis for the year ended December 31, 2003.

The following summarizes the activity for CA / T for FY04 (amounts in thousands):

<b>Total Project budget as of June 30, 2004 .....</b>	<b><u>\$ 14,625,000</u></b>
<b>Determination of Amounts Payable:</b>	
Cumulative authorized project invoices as of June 30, 2004 .....	\$ 13,316,707
Less: Amounts to be transferred to Massport as of December 31, 2003 .....	(365,000)
Less: Amounts transferred previous to December 31, 2003 to MTA and recognized as assets by MTA.....	(1,715,923)
Less: Amounts transferred to other entities.....	<u>(20,949)</u>
Subtotal.....	11,214,835
Less: Reduction of payable due to accumulated depreciation of assets in use to be transferred.....	<u>(247,327)</u>
<b>Due to Component Units - Central Artery / Tunnel Project as of June 30, 2004 .....</b>	<b><u>\$ 10,967,508</u></b>
<b>Reconciliation of Central Artery / Tunnel Fixed Assets to Assets to Due to Component Units -</b>	
<b>Central Artery / Tunnel Project as of June 30, 2004:</b>	
<b>Determination of Assets in Use:</b>	
Infrastructure - Central Artery / Tunnel Project.....	\$ 9,893,091
Less: Accumulated depreciation of infrastructure assets in use to be transferred.....	<u>(247,327)</u>
Net book value of Infrastructure - Central Artery / Tunnel Project.....	9,645,764
Land - Central Artery / Tunnel Project.....	<u>442,282</u>
<b>Net book value of Central Artery / Tunnel Project Assets in use to be transferred.....</b>	<b>10,088,046</b>
Construction in process - Central Artery / Tunnel Project.....	<u>1,244,462</u>
Subtotal.....	11,332,508
Less: Due to related organizations (Massport) .....	<u>(365,000)</u>
<b>Due to Component Units - Central Artery / Tunnel Project as of June 30, 2004 .....</b>	<b><u>\$ 10,967,508</u></b>

**6. FIXED ASSETS**

Depreciation expense is not charged to particular functions of the primary government. It is charged in the aggregate. Increases to accumulated depreciation differ from depreciation expense as shown on the statement of activities due to the reduction the payable to net book value of "Due to component unit – Central Artery / Tunnel Project," which is credited to depreciation expense. Capital asset activities for the fiscal year ended June 30, 2004 are as follows (amounts in thousands):

<i>Primary Government Governmental Activities</i>	July 1, 2003 Beginning Balance	Increases	Decreases	June 30, 2004 Ending Balance
Capital assets not being depreciated:				
Land .....	\$ 674,362	\$ 15,452	\$ 4,382	\$ 685,432
Land Central Artery / Tunnel Project .....	-	442,282	-	442,282
Construction in process - non - Central Artery / Tunnel Project .....	729,869	495,885	201,939	1,023,815
Construction in process - Central Artery / Tunnel Project .....	10,650,559	929,276	10,335,373	1,244,462
Total capital assets not being depreciated .....	12,054,790	1,882,895	10,541,694	3,395,991
Capital assets being depreciated:				
Buildings .....	3,494,370	188,251	19,640	3,662,981
Machinery and equipment .....	705,182	54,298	40,629	718,851
Infrastructure non - Central Artery / Tunnel Project.....	10,838,489	75,745	-	10,914,234
Infrastructure - Central Artery / Tunnel Project.....	-	9,893,091	-	9,893,091
Total capital assets being depreciated .....	15,038,041	10,211,385	60,269	25,189,157
Less, accumulated depreciation:				
Buildings .....	1,606,084	76,007	2,101	1,679,990
Machinery and equipment .....	581,767	51,678	35,463	597,982
Infrastructure non - Central Artery / Tunnel Project.....	4,022,184	264,146	-	4,286,330
Infrastructure - Central Artery / Tunnel Project.....	-	247,327	-	247,327
Total accumulated depreciation .....	6,210,035	639,158	37,564	6,811,629
Total capital assets being depreciated, net .....	<u>8,828,006</u>	<u>9,572,227</u>	<u>22,705</u>	<u>18,377,528</u>
Governmental activity capital assets, net .....	<u>\$ 20,882,796</u>	<u>\$ 11,455,122</u>	<u>\$ 10,564,399</u>	<u>\$ 21,773,519</u>

<i>Primary Government Business - Type Activities</i>	July 1, 2003 Beginning Balance	Increases	Decreases	June 30, 2004 Ending Balance
Capital assets not being depreciated:				
Land .....	\$ 62,904	\$ 375	\$ 3,918	\$ 59,361
Construction in process .....	154,962	92,009	110,738	136,233
Historical treasures .....	<u>701</u>	<u>2</u>	<u>-</u>	<u>703</u>
Total capital assets not being depreciated .....	218,567	92,386	114,656	196,297
Capital assets being depreciated:				
Buildings .....	2,301,599	194,081	1,312	2,494,368
Machinery and equipment .....	662,979	71,470	153,100	581,349
Library collections, not including historical treasures .....	<u>124,310</u>	<u>8,817</u>	<u>8,641</u>	<u>124,486</u>
Total capital assets being depreciated .....	3,088,888	274,368	163,053	3,200,203
Less, accumulated depreciation:				
Buildings .....	1,293,946	97,635	25,252	1,366,329
Machinery and Equipment .....	392,735	42,596	114,723	320,608
Library collections, not including historical treasures .....	<u>17,770</u>	<u>1,897</u>	<u>771</u>	<u>18,896</u>
Total accumulated depreciation .....	<u>1,704,451</u>	<u>142,128</u>	<u>140,746</u>	<u>1,705,833</u>
Total capital assets being depreciated, net .....	1,384,437	132,240	22,307	1,494,370
Business - type activity capital assets, net .....	<u>\$ 1,603,004</u>	<u>\$ 224,626</u>	<u>\$ 136,963</u>	<u>\$ 1,690,667</u>

***Discretely Presented Component Units*** – Fixed assets consist of the following at June 30, 2004 (amounts in thousands):

<i>Discretely Presented Component Units</i>	July 1, 2003 Beginning Balance	Increases	Decreases	June 30, 2004 Ending Balance
Capital assets not being depreciated:				
Land .....	\$ 420,815	\$ 121,594	\$ 54,073	\$ 488,336
Construction in process .....	<u>2,552,272</u>	<u>965,005</u>	<u>1,267,824</u>	<u>2,249,453</u>
Total capital assets not being depreciated .....	2,973,087	1,086,599	1,321,897	2,737,789
Capital assets being depreciated:				
Buildings .....	7,586,858	422,595	69,864	7,939,589
Machinery and equipment .....	2,134,526	231,583	15,192	2,350,917
Infrastructure .....	<u>1,406,656</u>	<u>932,313</u>	<u>894</u>	<u>2,338,075</u>
Total capital assets being depreciated .....	11,128,040	1,586,491	85,950	12,628,581
Less, accumulated depreciation.....	3,937,917	<u>363,050</u>	<u>-</u>	<u>4,300,967</u>
Total capital assets being depreciated, net .....	<u>7,190,123</u>	<u>1,223,441</u>	<u>85,950</u>	<u>8,327,614</u>
Discretely Presented Component Unit capital assets, net .....	<u>\$ 10,163,210</u>	<u>\$ 2,310,040</u>	<u>\$ 1,407,847</u>	<u>\$ 11,065,403</u>

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**7. SHORT-TERM FINANCING AND CREDIT AGREEMENTS**

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***Primary Government -***

Massachusetts General Laws authorize the Treasurer to issue temporary notes in anticipation of revenue or bond financing. When this short-term debt does not meet long-term financing criteria, it is classified as a fund liability. Short-term debt may be issued on either a stand-alone basis or through a commercial paper program maintained by the Commonwealth.

***A. General Fund***

The balance of revenue anticipation notes (RANs) outstanding may fluctuate during a fiscal year, but must be reduced to zero at June 30. During FY04, the Commonwealth issued RANs through its commercial paper program on a periodic basis to meet cash flow needs. A maximum of \$450,000,000 of RANs were outstanding at any time during the year. All RANs were retired before the end of June 2004.

***B. Capital Projects Funds***

The Commonwealth may issue bond anticipation notes (BANs) to temporarily finance its capital projects. BANs may be issued either on a stand-alone basis or through the Commonwealth's commercial paper program.

Beginning in FY03 and continuing through FY04, the Commonwealth periodically issued BANs through the commercial paper program. BANs were rolled over and paid down at various times during the fiscal year. No more than \$650,100,000 of BANs were outstanding under the commercial paper program at any time during FY04. At June 30, 2004, BANs totaling \$75,100,000 remain outstanding.

On December 31, 2003, Massport was expected to make an additional payment to the Commonwealth under the Transfer Agreement of \$50,000,000, which would have been applied against these BANs. However, under the terms of the Transfer Agreement, the final two payments of \$50,000,000 each are due on December 31, 2003 and 2004, respectively, only to the extent that Massport has received assets of commensurate value. Prior to December 31, 2003, Massport informed the Commonwealth that such assets had not been received and that Massport therefore withhold the final two payments until such assets were transferred.

***C. Line-of-Credit Facilities***

During FY04, the Commonwealth maintained line-of-credit facilities to provide liquidity support for commercial paper notes totaling \$1,000,000,000. The Commonwealth has a total of five line-of-credit facilities to provide such liquidity support, each in the amount of \$200,000,000. These facilities expire in periods from December 2004, through December 2006 at various times. The annual cost of these facilities ranges from 0.125% to 0.17%.

The following schedule details short – term financing and credit agreement activity for all funds for the fiscal year (amounts in thousands):

	Beginning Balance July 1, 2003	Issued / Drawn	Redeemed / Repaid	Ending Balance June 30, 2004	Credit Limit June 30, 2004
General Fund:					
Revenue anticipation notes.....	\$ -	\$ 450,000	\$ (450,000)	\$ -	\$ -
Line-of-credit agreements.....	-	-	-	-	1,000,000
Subtotal - General Fund activity.....	-	450,000	(450,000)	-	1,000,000
Capital Projects Funds:					
Bond anticipation notes.....	857,100	575,000	(1,357,000)	75,100	-
Subtotal - Capital Projects Funds activity.....	857,100	575,000	(1,357,000)	75,100	-
Total short-term financing and credit agreement activity.....	<u>\$ 857,100</u>	<u>\$ 1,025,000</u>	<u>\$ (1,807,000)</u>	<u>\$ 75,100</u>	<u>\$ 1,000,000</u>

As of June 30, 2004, no major component units had short – term debt outstanding.

The FY03 General Appropriation Act amended the RTAs' enabling statute. After July 1, 2003, bonds and notes issued by the various RTAs are no longer guaranteed by the Commonwealth and are not general obligations of the Commonwealth.

## 8. LONG-TERM OBLIGATIONS

Under the Constitution of the Commonwealth of Massachusetts, the Commonwealth may borrow money (a) for defense, (b) in anticipation of receipts from taxes or other sources, any such loan to be paid out of the revenue of the year in which the loan is made, or (c) by a two-thirds vote of the members of each house of the Legislature present and voting thereon. The Constitution further provides that borrowed money shall not be expended for any other purpose than that for which it was borrowed or for the reduction or discharge of the principal of the loan. In addition, the Commonwealth may give, loan or pledge its credit to another entity by a two-thirds vote of the members of each house of the Legislature. The Legislature may not in any manner allow the Commonwealth credit to be given or loaned to or in aid of any individual, or of any private association, or of any corporation, which is privately owned or managed.



The Commonwealth has waived its sovereign immunity and consented to be sued on contractual obligations, including bonds and notes issued by it and all claims with respect thereto. However, the property of the Commonwealth is not subject to attachment or levy to pay a judgment, and the satisfaction of any judgment generally requires legislative appropriation. Enforcement of a claim for the payment of principal or interest on bonds and notes of the Commonwealth may also be subject to the provisions of federal or Commonwealth statutes, if any, enacted to extend the time for payment or impose other constraints upon enforcement.

As of June 30, 2004, the Commonwealth had three types of long-term debt outstanding, general obligation bonds (inclusive of federal highway grant anticipation notes) and special obligation bonds.

The following is a summary of the Commonwealth's debt outstanding by type of debt (amounts in thousands):

	<u>Amount Outstanding</u>
<b><u>General Obligation Debt:</u></b>	
General obligation bonds:	
Fixed rate.....	\$ 12,203,178
Variable rate.....	1,364,480
Auction rate securities.....	401,500
College opportunity bonds.....	83,578
County debt assumed.....	675
Grant anticipation notes (inclusive of cross-over refunding notes).....	<u>1,908,015</u>
<b>Subtotal - general obligation debt.....</b>	<b>15,961,426</b>
<b><u>Special Obligation Debt:</u></b>	
Special obligation bonds (inclusive of cross-over refunding bonds):	
Fixed rate.....	\$ 1,335,276
Variable rate.....	<u>86,590</u>
<b>Subtotal - special obligation debt.....</b>	<b>1,421,866</b>
Discount / (premium) and issuance cost.....	<u>(1,120)</u>
<b>Total outstanding debt.....</b>	<b><u>\$ 17,382,172</u></b>

**A. General Obligation Bonds**

General Obligation Bonds are authorized and issued primarily to provide funds for Commonwealth-owned capital projects and Commonwealth supported local government improvements. They are backed by the full faith and credit of the Commonwealth and paid from the Governmental Funds, from which debt service principal and interest payments are appropriated. Massachusetts General Laws provide for the allocation of bond proceeds to these authorizations in arrears, as expenditures are made, unless the proceeds are allocated at the time of issuance. In addition, forms of general obligation bonds are issued for specific programs approved by the Legislature. These are as follows:

*College Opportunity Bonds*

Some Commonwealth general obligation debt is issued in the form of College Opportunity Bonds (COBs) as authorized by the Massachusetts General Laws. These bonds are sold to fund the Commonwealth's "U. Plan" which is part of a college savings program administered by the Massachusetts Educational Financing Authority. These bonds are privately placed and are structured to meet the needs of investors in this plan. Such bonds were initially issued in fiscal year 1996, and have been issued in each subsequent fiscal year, including FY04, during which approximately \$10,585,000, (including accretion), of such bonds were issued. Outstanding COBs have maturity dates ranging from 2005 through 2023. COBs have an accreting interest component payable at maturity. The annual accretion rate of each COB's maturity is a variable rate equal to the annual change in the Consumer Price Index (CPI) plus 2.0%. Assuming the CPI averages 3.5% during the life of the outstanding COBs the payments due at maturities of the COBs will total approximately \$171,533,000, including accretion. In addition, COBs pay current interest in the amount of 0.5% per year of the initial amount still outstanding. The full faith and credit of the Commonwealth back these bonds.

*County Debt Assumed*

Chapter 38 of the Acts of 1997 and Chapter 300 of the Acts of 1998 abolished governments of several Massachusetts counties on various effective dates. As part of these provisions, the Commonwealth assumed the outstanding debt of Middlesex County on July 1, 1997, of Hampden and Worcester Counties on July 1, 1998, that of Essex County on July 1, 1999 and that of Berkshire County on July 1, 2000. The county debt assumed has become general obligation debt of the Commonwealth. As of June 30, 2004, \$675,000 of these obligations remains outstanding.

*Variable Rate Demand Bonds*

Included in the long-term debt is \$1,451,070,000 of general obligation variable rate demand bonds (VRDBs) maturing from 2008 through 2030 in varying amounts, of which \$1,267,025,000 is swapped to fixed rates. The redemption schedule for these bonds is included in the bond redemption schedule contained herein. The interest rate on the VRDBs is determined either weekly or daily based on the activity of the Commonwealth's remarketing agents, and interest is paid monthly. On any reset date, holders of the VRDBs can require the Commonwealth (acting through its remarketing and tender agents) to repurchase the bonds (a "put"). The remarketing agent is authorized to use its best efforts to resell any repurchased bonds by adjusting the interest rates offered. The Commonwealth pays an annual fee to the remarketing agents equal to 0.05% of the outstanding par amount of the bonds.

Under the provisions of stand-by bond-purchase agreements entered into by the Commonwealth with certain commercial banks, the remarketing and tender agents are entitled to draw amounts sufficient to pay the purchase price of any bonds that cannot be resold. During any such period, the Commonwealth is required to pay the bank(s) at an interest rate based on their respective prime lending rates. If the remarketing agent is unable to resell any put bonds within six months of the put date, the stand-by bond-purchase agreements include provisions to convert any such bonds to installment loans payable over an extended period of time, with interest payable at a rate based on the bank(s) prime lending rate(s). The stand-by bond-purchase agreements expire on various dates between August of 2005 and December 2013. The Commonwealth is required to renew or replace these agreements as long as the VRDBs remain outstanding. The Commonwealth currently pays an annual fee to maintain these agreements, which range from 0.13% to 0.22% of the par amount of the bonds.

#### *Other Variable Rate Bonds*

As part of its refunding activities during FY03, the Commonwealth issued \$97,455,000 of refunding bonds which pay a variable rate interest that depends on changes in the Consumer Price Index (CPI). These bonds, which pay interest every six months, are not subject to periodic remarketing, nor do bondholders have the right to “put” such bonds back to the Commonwealth.

On June 29, 2004 as part of the Commonwealth’s issuance of the Convention and Exhibition Center Special Obligation Bonds, \$86,590,000 of such bonds were issued paying a variable rate of interest also indexed to changes in the CPI. Similar to the 2003 Bonds, the Convention Center Bonds pay interest semiannually, but mature serially from FY15 to FY18.

#### *Auction Rate Securities*

Also included in the long-term debt is \$401,500,000 of general obligation Auction Rate Securities (ARS) maturing in varying amounts from 2020 through 2030. The interest rate payable on the bonds changes weekly as determined pursuant to specified auction procedures. Interest on the bonds is payable weekly. In the case of a failed auction (i.e., insufficient bids to clear the market) existing buyers may be required to hold their bonds with interest payable at a rate equal to a percentage of an ARS industry index, up to a maximum rate of 12.0%.

### **B. Special Obligation Bonds**

The Commonwealth also issues special obligation revenue bonds as authorized by Massachusetts General Laws. Such bonds may be secured by all or a portion of revenues credited to the Highway Fund and are not general obligations of the Commonwealth. At June 30, 2004, the Commonwealth had outstanding \$1,405,930,000 of such special obligation bonds, of which \$1,331,946,000 is allocated to debt not subject to the Commonwealth’s statutory debt limit. These bonds are secured by a pledge of 6.86 cents of the 21 cent motor fuel excise tax imposed on gasoline.

In June of 2002, the Commonwealth sold \$319,130,000 of special obligation revenue bonds, Series 2002A. Of this amount, \$183,180,000 was issued to refund prior special obligation bonds. The escrow funded by the refunding bonds and related premium was used only to secure the principal related to \$190,075,000, (as well as exclusive of related call premiums) in previously issued special obligation bonds, some of which matured on June 1, 2004 and others will mature in June 1, 2006 and 2008. The interest related to these maturities is not

secured by this escrow. Rather, it will be paid from the existing stream of motor fuel excise taxes. Interest on a portion of the newly issued refunding bonds will be paid from the proceeds of the escrow until the aforementioned prior bonds are called for redemption. This technique, which is generally referred to as a “crossover refunding,” results in economic savings to the Commonwealth similar to a normal refunding, but does not meet the accounting definition of a legal defeasance of debt, in which case the defeased debt and the related escrow accounts would have been removed. Until such time as the escrow is used to repay the principal of the refunded bonds, such amounts will be reported in the Highway Capital Projects Fund. As of June 30, 2004, \$122,315,000 of these amounts remained outstanding.

On June 29, 2004, the Commonwealth issued \$686,715,000 of Special Obligation Bonds to permanently finance the costs of construction or renovation of the Commonwealth’s convention and exhibition centers in Boston, Springfield and Worcester. To date, these projects were financed primarily through the issuance of notes. The total proceeds from the sale were approximately \$706,729,000. The bonds are secured solely by pledged receipts of tax revenues within special districts surrounding those facilities and certain other moneys or securities established within credit facilities. The bonds mature from FY15 to FY34.

**C. Federal Highway Grant  
Anticipation Notes**

The Commonwealth also issued Federal Highway GANs to finance current cash flow for the Central Artery/Tunnel Project in anticipation of future federal reimbursements. Section 9 through 10D of Chapter 11 of the Acts of 1997, as amended by Chapter 121 of the Acts of 1998, authorizes the Commonwealth to sell up to \$1,500,000,000 in GANs. All Federal Highway Construction reimbursements and reimbursements from the federal highway construction trust funds are pledged to the repayment of the GANs. These notes are secured by the pledge of Federal Highway Construction Reimbursements without a general obligation pledge. Under certain limited circumstances, a portion of the revenue from the Commonwealth’s motor fuels excise tax may be used to pay debt service on the GANs.

During FY04, the Commonwealth sold \$408,015,000 of GANs refunding notes, Series 2003A. These notes are Special Obligations of the Commonwealth. The escrow funded by the notes will be used to secure the principal related to \$418,340,000 of GANs, including related call premiums, in previously issued series callable on December 15, 2008 and 2010. The interest related to these maturities is not secured by this escrow. Rather, it will be paid from Commonwealth appropriations or the existing stream of future federal grants. Interest on the newly issued refunding notes will be paid from the proceeds of the escrow until the aforementioned prior notes are called for redemption. For the purposes of the pledge but not for accounting purposes, at the time of call, the refunding notes will become GANs. This results in economic savings to the Commonwealth similar to a normal refunding, but does not meet the accounting definition of defeasance of debt, in which case the defeased debt and the related escrow accounts would have been removed. Until such time as the escrow is issued to repay the principal of the refunded notes, such amounts will be reported in the Grant Anticipation Note Trust Fund. As a result of this transaction, the Commonwealth will reduce its debt service by \$23.9 million over the next 12 years, resulting in an economic gain of \$15.4

million on a present value basis. Inclusive of the cross-over refunding notes, at June 30, 2004, the Commonwealth has \$1,907,340,000 of GANs outstanding, including accreted interest on capital appreciation bonds with maturity dates ranging from 2006 to 2015.

#### **D. Interest Rate Swap Agreements**

The Commonwealth enters into interest rate swap agreements to modify interest rates on outstanding debt. Other than the net interest expenditures resulting from these agreements, no amounts are recorded in the financial statements.

##### *Objective of the Interest Rate Swap Agreements*

In connection with the issuance of variable rate refunding bonds in 1997, 1998, 2001 and 2003, the Commonwealth entered into interest rate swap agreements with certain counterparties. The purpose of these agreements is to effectively fix the interest rate payable on the corresponding variable rate refunding bonds, and to achieve an all-in synthetic interest rate that is lower than the rate that could have been achieved on a natural fixed rate basis at the time the agreements were entered into.

##### *Terms of the Interest Rate Swap Agreements*

The bonds and related swap agreements have final maturities ranging from 2013 to 2021. The swaps' total notional value of \$1,451,070,000 matches the par amount of the related variable rate refunding bonds. Under the swap agreements, the Commonwealth pays the relevant counterparties' fixed rates ranging from 4.15% to 5.25% and receives variable rate payments equal to the amount of variable rate payments the Commonwealth pays on the related variable rate refunding bonds.

The following chart details the Commonwealth's outstanding swaps and related bond issuances:

<u>Associated Bond Issue</u>	<u>Notional Amounts (thousands)</u>	<u>Effective Date</u>	<u>Fixed Rate Paid (Range)</u>	<u>Variable Rate Received</u>	<u>Fair Market Values (thousands)</u>	<u>Final Termination Date</u>	<u>Counterparty Credit Rating</u>
<i>General Obligation Bonds:</i>							
Series 1997B.....	\$ 162,768	8/12/1997	4.659%	Actual Bond Rate	\$ (12,949)	August 1, 2015	AA+/Aaa
Series 1997B.....	108,512	8/12/1997	4.659%	Actual Bond Rate	(11,005)	August 1, 2015	AAA/Aaa
Series 1998A & B....	299,712	9/17/1998	4.174%	Actual Bond Rate	(19,219)	September 1, 2016	AAA/Aaa
Series 1998A & B....	199,808	9/17/1998	4.174%	Actual Bond Rate	(8,219)	September 1, 2016	AAA/Aaa
Series 2001B & C....	496,225	2/20/2001	4.150%	Actual Bond Rate	(31,836)	January 1, 2021	AAA/Aaa
Series 2003B.....	87,455	3/12/2003	4.500%	Actual Bond Rate	1,521	March 1, 2014	AA+/Aaa
Series 2003B.....	<u>10,000</u>	3/12/2003	4.500%	Actual Bond Rate	<u>297</u>	March 1, 2013	A/A2
Subtotal.....	<u>1,364,480</u>				<u>(81,410)</u>		
<i>Special Obligation Dedicated Tax Revenue Bonds (CPI Based Swaps):</i>							
Series 2004.....	28,863	6/29/2004	4.45% - 5.25%	Actual Bond Rate	(1,301)	January 1, 2018	A/A1
Series 2004.....	28,863	6/29/2004	4.45% - 5.25%	Actual Bond Rate	(1,303)	January 1, 2018	A+/Aa3
Series 2004.....	<u>28,863</u>	6/29/2004	4.45% - 5.25%	Actual Bond Rate	(1,078)	January 1, 2018	AA-/Aa2
Subtotal.....	86,590				(3,682)		
Total.....	\$ 1,451,070				\$ (85,092)		

*Fair Market Value of the Interest Rate Swap Agreements*

Swap rates for the types and remaining terms of the Commonwealth's swap agreements are generally lower (as of June 30, 2004) than those that prevailed when the various swap contracts were entered into. This is the result of two factors: (1) lower interest rates in general; and (2) the shortening of the remaining terms of the swap contracts due to the passage of time and an upward sloping yield curve for such instruments. As a result, the Commonwealth's swap agreements have an estimated fair market value of negative \$85,092,000 as of June 30, 2004. If all the Commonwealth's swap agreements had been terminated as of the end of fiscal year 2004, the Commonwealth would have been required to make a payment of this magnitude. Although the Commonwealth has the option of terminating its swap agreements at any time (and either make or receive any termination payment due), the Commonwealth's counterparties do not have such an option. Therefore, the Commonwealth would only have to make a payment of the magnitude estimated if certain termination events occurred, as described below.

*Credit Risk of the Interest Rate Swap Agreements*

The swap contracts require that the Commonwealth's counterparties maintain certain ratings levels. If they fail to maintain such ratings, the Commonwealth could choose to terminate the related swap agreement and receive or pay a termination payment depending on the interest rates at the time. Similarly, the Commonwealth is required to maintain a certain credit rating under the agreements, generally in the "A" category. If the Commonwealth's rating fell below those levels, the Commonwealth's counterparties could choose to make variable rate payments based on a market index (instead of the actual bond rate) which would subject the Commonwealth to basis risk, as noted below.

*Basis, Market and Rollover Risk of the Interest Rate Swap Agreements*

Because the terms on the interest rate swap agreements require the Commonwealth's counterparties to make variable rate payments equal to those the Commonwealth makes on the related variable rate bonds, the Commonwealth is not generally subject to any basis or market risk as a result of these agreements. Under certain circumstances, such as a downgrade of the credit rating of the bonds or the enactment of tax-related legislation which causes the related bonds to trade differently, the swap agreements provide that the Commonwealth's counterparties, may, at their option, pay a variable rate that is based on one or more market indices such as LIBOR or the BMA swap index. Under these circumstances, the Commonwealth would be subject to basis risk if these indices varied significantly from the variable rates that were determined for the Commonwealth's variable rate demand bonds through the associated remarketing process.

Swap contracts generally have the same maturity dates and amortizations as the related bonds. Therefore, the Commonwealth is not subject to any rollover risk as a result of these agreements.

*Termination Risk of the Interest Rate Swap Agreements*

The swap contracts use the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The swap agreements are not otherwise subject to termination except at the Commonwealth's option. If one or more of the swap agreements were terminated, then related variable rate bonds would no longer be hedged and

the Commonwealth would no longer be paying a synthetic fixed rate with respect to the bonds. In addition, if at the time of termination, the swap had a negative fair value, the Commonwealth would incur a loss and would be required to settle with the related counterparty or counterparties at the swaps' fair market values.

The Commonwealth is party to an interest rate swap agreement relating to the Commonwealth's General Obligation Refunding Bonds, 2001 Series B and 2001 Series C, pursuant to which the Commonwealth makes payments at a fixed rate of 4.15% per annum and receives payments from its swap counterparty at a floating rate based on the actual rate on its bonds, which are variable rate obligation bonds. The notional amount of the swap currently is \$496,225,000 and the scheduled termination date is January 1, 2021. Swap payments are made monthly, with the Commonwealth netting its fixed rate obligation against the floating rate amount due from the swap counterparty. The swap documentation provide that the method for determining the floating rate obligation of the counterparty may change upon an "Event of Taxability" as defined therein. The swap counterparty has asserted that an Event of Taxability has occurred and that, as a result, commencing May 3, 2004, the Commonwealth's monthly net payments to the counterparty must be increased. The Commonwealth disagrees with this assertion and, on April 23, 2004, filed a complaint in Suffolk County Superior Court seeking a declaratory judgment and related preliminary injunction relief. The swap payment made by the Commonwealth on May 3, 2004 and each monthly payment made thereafter have been calculated based on the pre-existing method. Had they been calculated as asserted by the swap counterparty, under market conditions on each such payment date through October 1, 2004, the payments would have been approximately \$1.0 million greater in the aggregate. The termination value of the swap as of June 30, 2004 is believed to have been approximately \$31.8 million in favor of the swap counterparty and will vary from time to time. The Commonwealth has continued to make net swap payments based on its actual variable rate bond payments pending legal developments.

Debt service on the variable rate bonds is as follows (assuming a short term rate of 2% and a CPI rate of 3%):

Fiscal Year Ending June 30	Variable-Rate Bonds		Interest Rate		Total
	Principal	Interest	Swaps, Net		
2005.....	\$ -	\$ 32,623,645	\$ 31,965,358	\$	64,589,003
2006.....	-	32,623,645	31,965,358		64,589,003
2007.....	-	32,623,645	31,965,358		64,589,003
2008.....	2,340,000	32,588,545	31,927,204		66,855,749
2009.....	3,870,000	32,518,795	31,851,386		68,240,181
2010-2014.....	495,555,000	142,580,842	136,844,068		774,979,910
2015-2019.....	753,465,000	50,875,480	49,818,691		854,159,171
2020-2024.....	195,840,000	4,214,800	4,530,910		204,585,710
Total	<u>\$ 1,451,070,000</u>	<u>\$ 360,649,397</u>	<u>\$ 350,868,333</u>	<u>\$</u>	<u>2,162,587,730</u>

**E. Outstanding Debt**

For financial reporting purposes, long-term debt is carried at its face value, which includes discount and any issuance costs. The outstanding amount represents the total principal to be repaid. For capital appreciation bonds, the outstanding amount represents total principal and accreted interest to be repaid. When short-term debt has been refinanced on a long-term basis, it is reported as outstanding at its face amount.

The amount of long-term debt authorized but unissued is measured in accordance with the statutory basis of accounting. Only the net proceeds (exclusive of discount and costs of issuance) are deducted from the total authorized by the Legislature.

Long-term debt outstanding (including discount and issuance cost) and debt authorized and unissued at June 30, 2004 is as follows (amounts in thousands):

<u>Purpose</u>	<u>Bonds Outstanding</u>	<u>Fiscal Year Maturities</u>	<u>Authorized and Unissued</u>
GANs.....	\$ 1,907,340	2006-2015	\$ -
Capital Projects:			
General.....	5,496,512	2005-2031	3,958,557
Highway.....	8,774,386	2005-2034	2,666,991
Local Aid.....	1,142,134	2005-2031	99,146
Other.....	61,800	2005-2029	103,299
	<u>15,474,832</u>		<u>6,827,993</u>
Total.....	<u>\$ 17,382,172</u>		<u>\$ 6,827,993</u>

Interest rates on the Commonwealth's debt outstanding at the end of FY04 ranged from 0.0% to 8.0%.

Changes in long-term debt outstanding (including discount and issuance cost) and bonds authorized - unissued for the year ended June 30, 2004 are as follows (amounts in thousands):

	<u>Bonds Outstanding</u>	<u>Authorized and Unissued</u>
Balance July 1, 2003.....	\$ 15,962,506	\$ 8,721,581
General and special obligation bonds:		
Principal, less discount and issuance costs.....	1,993,086	(1,993,086)
Net premium and issuance costs.....	(67,096)	-
General obligation refunding bonds:		
Principal on Refunding Bonds.....	2,936,710	-
Principal on Refunded Bonds.....	(2,750,667)	-
Retired discount on Refunded Bonds.....	66,077	-
Increase in bonds authorized.....	-	310,461
Decrease in bonds authorized.....	-	(210,963)
Bonds retired.....	<u>(758,444)</u>	<u>-</u>
Balance June 30, 2004.....	<u>\$ 17,382,172</u>	<u>\$ 6,827,993</u>



*Business Type Activities – Colleges and University Debt*

Building authorities related to the University of Massachusetts and the state colleges have issued bonds for construction of higher education facilities and equipment. Such bonds are guaranteed by the Commonwealth in an aggregate amount not to exceed \$200,000,000. The bond agreements generally provide that revenues from student fees are pledged as collateral on the bonds and establish bond reserve funds, bond funds, and maintenance reserve funds. The University of Massachusetts and state colleges have also entered into various loan agreements as participants in the Massachusetts Health and Educational Facilities Authority's (MHEFA) ongoing capital asset program to finance construction projects and equipment.

At June 30, 2004, debt service requirements to maturity for principal (including discount, capital appreciation and issuance costs) and interest including all variable rate interest not hedged by swap agreements (assumed interest rate is 5%) are as follows (amounts in thousands):

Fiscal Year Ended June 30	Governmental Activities		Business - Type Activities	
	<b>General Obligation</b>		<b>Revenue Obligation</b>	
	Principal	Interest	Principal	Interest
2005 .....	\$ 880,272	\$ 843,653	\$ 43,621	\$ 49,440
2006 .....	998,102	829,576	24,852	49,054
2007 .....	1,038,302	779,519	25,982	48,063
2008 .....	1,069,225	725,953	31,867	47,032
2009 .....	1,076,809	671,376	33,286	45,714
2010 - 2014 .....	5,116,215	2,519,304	184,472	204,729
2015 - 2019 .....	3,455,335	1,360,286	192,701	157,088
2020 - 2024 .....	2,252,708	634,770	207,449	103,487
2025 - 2029 .....	872,914	292,264	164,056	55,495
2030 - 2034 .....	622,290	59,900	124,330	11,308
2035 - 2039 .....	-	-	16,479	234
Total long - term debt .....	17,382,172	8,716,601	1,049,095	771,644
Less: Current Portion .....	(880,272)	(843,653)	(43,621)	(49,440)
Long - term debt .....	\$ 16,501,900	\$ 7,872,948	\$ 1,005,474	\$ 722,204

The Commonwealth issued bonds and notes through both competitive and negotiated sales during FY04. The costs for legal counsel and underwriting fees for bond sales were \$879,000 and \$23,884,000 respectively. In addition, the Commonwealth paid \$156,000 for disclosure counsel services.

#### **F. Bonds Defeased Through Refunding**

As authorized by the Massachusetts General Laws, the Commonwealth advance refunded certain general obligation bonds through the issuance of \$2,528,695,000 of general obligation refunding bonds (exclusive of the aforementioned special obligation refunding bonds) during FY04. Net proceeds totaling approximately \$2,829,668,000 were used to purchase U.S. Government and U.S. Government Agency securities which were deposited in irrevocable trusts with an escrow agent to provide for all future debt service payments of the refunded bonds. As a result, the refunded bonds are considered to be defeased, and the liabilities therefore are not reflected in the financial statements. As a result of these refundings, the Commonwealth decreased current year debt service payments and has taken advantage of lower interest rates, and it has decreased its aggregate debt service payments by approximately \$203,600,000 over the next 20 years and will experience an economic gain (the difference between the present values of the debt service payments of the refunded and refunding bonds) of approximately \$107,200,000. At June 30, 2004, approximately \$1,940,005,000 of the bonds refunded remain outstanding and are defeased.

**G. Prior Defeasance**

In prior years, the Commonwealth defeased certain general and special obligation bonds by purchasing securities (from the proceeds of refunding bonds or from surplus operating funds) and placing them in irrevocable trusts to provide for all future debt service payments on the defeased bonds. Accordingly, the trust account assets and the liabilities for the defeased bonds are not included in the financial statements. At June 30, 2004, approximately \$4,327,954,000 of bonds outstanding from activities in prior fiscal years are considered defeased.

**H. Statutory Debt Limit**

The Massachusetts General Laws establish limits on the amount of direct debt outstanding. By statutorily limiting the Commonwealth's ability to issue direct debt, this limit provides a control on annual capital spending. The direct debt limit for FY04 was approximately \$12,822,414,000. Outstanding debt subject to the limit at June 30, 2004 was approximately \$12,459,055,000. The limit increases 5% per year.

By Legislative action, for purposes of determining compliance with the limit, outstanding direct debt is defined to include general obligation bonds and minibonds at the amount of their original net proceeds. It excludes BANs and discount and issuance costs, if any, financed by these bonds. It also excludes special obligation bonds, GANs, refunded bonds, certain refunding bonds, debt issued by counties, and debt issued in conjunction with the MBTA forward funding.

The amounts excluded from the debt limit are as follows (amounts in thousands):

	Debt Outstanding
Balance June 30, 2004.....	\$ 17,382,172
Less amounts excluded:	
Premium / (discount) and issuance cost.....	1,120
Special obligation principal.....	(1,347,882)
GANs principal.....	(1,908,015)
County debt assumed.....	(675)
MBTA forward funding.....	(601,027)
Central Artery / Tunnel.....	(1,066,638)
	<hr/>
Outstanding Direct Debt.....	<u>\$ 12,459,055</u>

# **I. Changes in Long - Term Liabilities**

Other long-term liabilities will be liquidated in the future from governmental funds. During the year ended June 30, 2004, the following changes occurred in liabilities reported as part of the long-term liabilities in the statement of net assets (amounts in thousands):

<i>Primary Government Governmental Activities</i>	Interest Rates	Maturity Through	July 1, 2003 Beginning Balance	Increases	Decreases	June 30, 2004 Ending Balance	Due Within One Year
Long - term debt:							
General obligation bonds .....	0.00 - 8.00%	2031	\$ 13,645,664	\$ 3,828,381	\$ 3,346,650	\$ 14,127,395	\$ 846,476
Special obligation bonds .....	4.00 - 5.50%	2034	748,124	693,400	93,642	1,347,882	27,170
Grant anticipation notes .....	0.00 - 7.00%	2015	1,500,000	408,015	-	1,908,015	-
Unamortized (premiums) / discounts:							
General obligation bonds .....			78,457	(60,411)	2,555	15,491	6,426
Special obligation bonds .....			(9,063)	(6,685)	188	(15,936)	200
Grant anticipation notes .....			(675)	-	-	(675)	-
Total long - term debt .....			15,962,507	4,862,700	3,443,035	17,382,172	\$ 880,272
Less: Current portion .....			(728,485)	880,272	728,485	(880,272)	
Net long - term debt .....			<u>15,234,022</u>	<u>3,982,428</u>	<u>2,714,550</u>	<u>16,501,900</u>	
Other long - term liabilities:							
Due to Component Units - Central Artery / Tunnel Project.....			10,285,559	681,949	-	10,967,508	
Due to related organizations.....			365,000	-	-	365,000	
School construction grants and other contract assistance payable.....			3,547,944	333,228	288,818	3,592,354	
Other liabilities.....			<u>598,738</u>	<u>644,786</u>	<u>598,738</u>	<u>644,786</u>	
Total other long - term liabilities.....			14,797,241	1,659,963	887,556	15,569,648	
Total non - current liabilities .....			<u>\$ 30,031,263</u>	<u>\$ 5,642,391</u>	<u>\$ 3,602,106</u>	<u>\$ 32,071,548</u>	
<i>Business - Type Activities</i>	Interest Rates	Maturity Through	July 1, 2003 Beginning Balance	Increases	Decreases	June 30, 2004 Ending Balance	Due Within One Year
Long - term debt:							
Revenue obligation debt .....	0.0 - 7.5%	2037	\$ 673,398	\$ 402,387	\$ 26,690	\$ 1,049,095	\$ 43,621
Other long - term liabilities:							
Compensated absences .....			142,427	22,611	17,211	147,827	92,577
Capital lease obligations.....			91,934	9,323	27,286	73,971	15,852
Other liabilities.....			86,965	51,524	52,557	85,932	-
Total other long - term liabilities.....			321,326	83,458	97,054	307,730	-
Total Long - term liabilities.....			<u>994,724</u>	<u>485,845</u>	<u>123,744</u>	<u>1,356,825</u>	<u>\$ 152,050</u>
Less: Current portion.....			(133,240)	<u>152,050</u>	<u>133,240</u>	(152,050)	
Total non - current liabilities .....			<u>\$ 861,484</u>	<u>\$ 333,795</u>	<u>\$ (9,496)</u>	<u>\$ 1,204,775</u>	

**Discretely Presented Component Units** – Bonds and notes outstanding at June 30, 2004 (December 31, 2003 for MTA), net of unamortized discounts and premiums, along with unamortized losses on refundings of approximately \$236,893,000, are as follows (amounts in thousands):

<b>Discretely Presented Component Units</b>			July 1, 2003 Beginning Balance	Increases	Decreases	June 30, 2004 Ending Balance	Due Within One Year
Major component units:							
MBTA .....	2.00 - 7.00%	2005-2034	\$ 4,190,340	\$ 1,195,725	\$ 881,560	\$ 4,504,505	\$ 107,870
MTA .....	3.90 - 5.65%	2005-2039	2,528,788	-	13,050	2,515,738	39,935
MWPAT .....	3.00 - 6.375%	2005-2030	2,055,060	311,580	87,245	2,279,395	99,260
Nonmajor component units .....	1.77 - 9.00%	2005-2034	1,211,618	115,586	82,957	1,244,247	39,455
Total bonds payable .....			9,985,806	1,622,891	1,064,812	10,543,885	286,520
Compensated absences .....			24,681	15,986	16,178	24,489	18,549
Total Component Units .....			<u>\$ 10,010,487</u>	<u>\$ 1,638,877</u>	<u>\$ 1,080,990</u>	<u>\$ 10,568,374</u>	<u>\$ 305,069</u>

The amounts below represent the gross face amounts of bonds and notes outstanding and may differ from the amounts included in the combined balance sheet due to treatment of original issue discount in the general-purpose financial statements. Maturities of principal and interest are as follows (as of December 31, 2003 for MTA) (amounts in thousands):

Fiscal Year Ended June 30,	Massachusetts Bay Transportation Authority		Massachusetts Turnpike Authority		Massachusetts Water Pollution Abatement Trust		Nonmajor Component Units		Total	
	Principal	Interest	Principal	Interest	Principal	Interest	Principal	Interest	Principal	Interest
2005.....	\$ 106,735	\$ 213,810	\$ 39,935	\$ 119,066	\$ 99,260	\$ 114,523	\$ 39,397	\$ 68,103	\$ 285,327	\$ 515,502
2006.....	88,835	223,704	19,535	118,054	100,550	110,348	68,572	65,160	277,492	517,266
2007.....	160,685	219,746	19,890	117,009	103,555	109,540	31,638	56,289	315,768	502,584
2008.....	148,885	212,337	20,555	115,927	105,915	100,805	23,345	55,418	298,700	484,487
2009.....	152,630	203,702	21,620	114,770	108,645	93,912	25,534	53,486	308,429	465,870
2010 - 2014.....	912,715	874,606	247,195	535,195	564,094	401,116	153,423	245,261	1,877,427	2,056,178
2015 - 2019.....	874,455	618,915	279,580	536,827	542,675	247,991	213,539	200,696	1,910,249	1,604,429
2020 - 2024.....	993,365	371,085	355,771	581,908	394,930	119,283	214,569	164,684	1,958,635	1,236,960
2025 - 2029.....	703,605	145,616	299,359	497,061	179,595	44,222	193,485	117,262	1,376,044	804,161
2030 - 2034.....	333,160	15,140	124,013	262,998	80,176	7,781	196,975	42,444	734,324	328,363
2035 - 2039.....	27,435	(1,013)	946,285	108,859	-	-	34,660	12,943	1,008,380	120,789
2040 - 2044.....	-	-	142,000	-	-	-	30,690	4,357	172,690	4,357
Total long -										
- term debt*.....	4,502,505	3,097,648	2,515,738	3,107,674	2,279,395	1,349,521	1,225,827	1,086,103	10,523,465	8,640,946
Current portion*.....	(106,735)	(213,810)	(39,935)	(119,066)	(99,260)	(114,523)	(39,397)	(68,103)	(285,327)	(515,502)
Long - term debt*.....	\$ 4,395,770	\$ 2,883,838	\$ 2,475,803	\$ 2,988,608	\$ 2,180,135	\$ 1,234,998	\$ 1,186,430	\$ 1,018,000	\$ 10,238,138	\$ 8,125,444

The MBTA issued certificates of participation (COPs) in the amounts of approximately \$28,565,000 on December 15, 1988 and approximately \$85,795,000 on August 30, 1990 to finance the purchase of commuter rail coaches. Under the terms of the "Forward Funding" of the MBTA, the COPs payments are not reimbursable by the Commonwealth, but are guaranteed.

The COPs bear interest at rates ranging from 7.75% to 7.80% and mature as follows (amounts in thousands):

Fiscal Year Ended June 30	Principal	Interest
2005.....	\$ 1,135	\$ 176
2006.....	<u>1,135</u>	<u>88</u>
	2,270	264
Less: Current Portion.....	(1,135)	(176)
Long Term Portion.....	<u>\$ 1,135</u>	<u>\$ 88</u>

The remaining outstanding principal balance of COPs that were defeased in prior years is \$9,075,000 at June 30, 2004.

In prior years, the MBTA defeased in-substance several General Transportation System Bonds by placing the proceeds of new bonds in an irrevocable trust fund to provide for future debt service payments on the old debt. Accordingly, the trust account asset and the liability for the defeased bonds are not included in the accompanying financial statements. On June 30, 2004, approximately \$1,214,675,000 of these bonds outstanding are considered defeased.

In FY04 and prior years, the MWPAT defeased in-substance ten series' of Loan Program Bonds similarly to the MBTA. On June 30, 2004, approximately \$477,555,000 of these bonds outstanding are considered defeased.

#### *Interest Rate Swap Agreements – Discretely Presented Component Units*

The MBTA has entered into interest rate swaps and swaptions (referred to herein collectively as Swaps) in order to lower its cost of capital, protect against rising interest rates, lock in rate savings and to realize refinancing savings according to schedules that suit the Component Units' needs. When the Component Unit has entered into Swaps, it has done so in order to: (1) provide lower costs fixed rate financing for its capital needs through synthetic fixed rate structures; (2) lock in long – term fixed rate returns on invested assets in its required reserve funds; and (3) create synthetic refinancing with cash flow savings realized as the Component Unit designates.

*Summary of Swap Transactions by Category – Synthetic Fixed Rate Swap Transactions*

From FY00 through FY02, MBTA executed swap agreements, associated with particular series of bonds. On one of the agreements, the MBTA will receive a \$4,338,000 payment for the counterparty, due in FY07. The transactions are summarized as follows: (amounts in thousands):

<u>Fixed Rate Paid</u>	<u>Variable Receive Rate</u>	<u>Component Unit</u>	<u>Notional Amount</u>	<u>Effective Date</u>	<u>Maturity Date</u>
4.93% .....	BMA	MBTA	\$ 188,000	June, 2000	2005
5.2% .....	BMA	MBTA	87,805	December, 2001	2022
4.13% .....	CPI+79bps.	MBTA	25,005	February, 2004	2020
			<u>\$ 300,810</u>		

*Swap Payments and Associated Debt*

As of June 30, 2004, debt service requirements on the various bond issuances of the MBTA that have swap payments applied to them were calculated by applying fixed rates ranging from 4.13% to 5.2% and assuming variable rates of 1.02%, using BMA and 4.679% plus 79 basis points for the CPI – based bonds. Debt service related to these swaps is as follows (amounts in thousands).

<u>Fiscal Year Ending June 30,</u>	<u>Variable - Rate Bonds Principal</u>	<u>Interest</u>	<u>Interest Rate Swap, Net</u>	<u>Total</u>
2005 .....	\$ -	\$ 4,183	\$ 9,485	\$ 13,668
2006 .....	-	2,585	3,456	6,041
2007 .....	-	2,265	2,250	4,515
2008 .....	-	2,265	2,250	4,515
2009 .....	-	2,265	2,250	4,515
2010 - 2014 .....	12,325	11,246	11,002	34,573
2015 - 2019 .....	37,870	9,565	5,768	53,203
2020 - 2022 .....	62,615	2,058	2,530	67,203
Total	<u>\$ 112,810</u>	<u>\$ 36,432</u>	<u>\$ 38,991</u>	<u>\$ 188,233</u>

*Swaptions for Forward Refundings*

In addition, the MBTA has four swaptions generally exercisable from FY06 through FY11 on its variable rate general transportation system bonds. The swaptions are summarized as follows (amounts in thousands):

Execution Date	Notional Amount	Lump - Sum Payment From Counterparty	Due date of Payment	Counterparty Option Exercise Dates	Term of Swap	Fixed Payable Swap Rate	Variable Receivable Swap Rate	Counterparty Credit Rating as of June 30, 2004	Fair Value at June 30, 2004
FY02.....	\$ 188,000	\$ 12,230	FY06	Each March & September 2005 - 2010	2030	5.000%	67% of one-month LIBOR	Aa2 / AA+	\$ (11,819)
FY02.....	79,645	4,140	FY06	Each March & September 2009 - 2011	2030	5.610%	BMA	Aaaa / AAA	(1,070)
FY03.....	123,170	10,833	In annual installments from FY04 to FY20	Each March & September 2005 - 2010	2025	5.093%	BMA	Aa2 / AA+	(2,091)
FY03.....	<u>96,085</u>	<u>6,728</u>	In annual installments from FY04 to FY20	Each March & September 2006 - 2011	2026	5.037%	BMA	Aa2 / AA+	<u>(1,285)</u>
	<u>\$ 486,900</u>	<u>\$ 33,931</u>							<u>\$ (16,265)</u>

*Credit Risk*

Because all of the MBTA's swaps rely upon the performance of third parties who serve as swap counterparties, both are exposed to credit risk, or the risk that a swap counterparty fails to perform according to its contractual obligations. The appropriate measurement of this risk at the reporting date is the fair value of the swaps. All fair values have been calculated using the Mark to Market or Par Value Method. To mitigate credit risk, the Component Units maintain strict credit standards for swap counterparties. For the MBTA, all swap counterparties for both Moody's and Standard & Poors rate longer-term swaps are in the "AA" category. On the MBTA's swap that matures in FY06, the counterparty is rated in the "A" category by both agencies. To further mitigate credit risk, the MBTA's swap documents require counterparties to post collateral for the MBTA's benefit if they are downgraded below a designated threshold.

*Basis Risk*

The MBTA is exposed to basis risk if the relationship between the floating index the MBTA receives on the swaps (BMA or 67% of LIBOR) falls short of the variable rate on the associated bonds. Should this occur, the expected savings may not be realized. As of June 30, 2004, the BMA rate was 1.08% while the variable rates on the associated MBTA bonds ranged from 1.02% to 1.38%.

*Termination Risk*

The MBTA's swap agreements do not contain any out of the ordinary events that would expose them to significant termination risk. In keeping with market standards, all parties may terminate each swap if the other party fails to perform under the terms of the contract. In addition the swap documents allow either party to terminate in the event of a significant loss of creditworthiness. The MBTA views such events to be remote. If at the time of the termination a swap has a negative value, the MBTA would be liable to the counterparty for a payment equal to the fair value of each swap.

*Rollover Risk*

Only the MBTA's 2000 series bonds are exposed to rollover risk because the swap for the bonds terminates prior to maturity of the bonds. Upon termination of the swap, the MBTA will no longer realize the synthetic rate on the 2000 bonds and will be exposed to floating rate risk on the underlying bonds if no new hedge is put in place.

*Market Access Risk and Potential Basis Risk*

In the case of the swaptions, other than the FY02 swaption, if any option is exercised and refunding bonds are not issued, the bonds expected to be refunded would not be refunded and the MBTA would make net swap payments as required by the terms of each contract. There is no market access risk for the FY02 swaption. If any of the options are exercised, the actual savings ultimately recognized by the transactions will be affected by the relationship between the interest rate terms of the variable rate bonds versus the variable payment on the swap.

## 9. INDIVIDUAL FUND DEFICITS

Certain funds within the Governmental Fund Type have fund deficits at June 30, 2004 as follows (amounts in thousands):

<u>Fund</u>	<u>Amount</u>
Major governmental funds:	
Highway .....	\$ 662,801
Other governmental funds:	
Federal Grants.....	4,636
General Capital Projects.....	283,256
Capital Expenditure Reserve.....	98,829
Highway Capital Projects .....	183,737



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## 10. RETIREMENT SYSTEMS

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### *Primary Government*

The Commonwealth is statutorily responsible for the pension benefits for Commonwealth employees (members of the State Employees' Retirement System) and for teachers of the cities, towns, regional school districts throughout the Commonwealth and Quincy College (members of the Teachers' Retirement System, except for teachers in the Boston public schools, who are members of the State-Boston Retirement System but whose pensions are also the responsibility of the Commonwealth). The members of the retirement systems do not participate in the Social Security System.

The Commonwealth has assumed responsibility for payment of cost-of-living adjustments (COLA) for the separate (non-teacher) retirement systems of its cities, towns and counties, granted in fiscal year 1981 to 1996. The Commonwealth is statutorily required to have an actuarial valuation once every three years and every two years to confirm to the requirements of GAAP.

### *Plan Descriptions*

The *State Employees' Retirement System* (SERS) is a single employer defined benefit public employee retirement system (PERS), covering substantially all employees of the Commonwealth and certain employees of the independent authorities and agencies, including the state police officers at the Massachusetts Port Authority and the Massachusetts Turnpike Authority. The SERS is administered by the Commonwealth and is part of the reporting entity and does not issue a stand alone financial report.

The *Teachers' Retirement System* (TRS) is an agent multiple employer defined benefit PERS. The Commonwealth is a non-employer contributor and is responsible for all contributions and future benefit requirements of the TRS. The TRS covers certified teachers in cities (except the City of Boston), towns, regional school districts and Quincy College. The TRS is administered by the Commonwealth and is part of the reporting entity and does not issue a stand-alone financial report.

The *State – Boston Retirement System* (SBRS) is a hybrid multiple employer defined benefit PERS. SBRS provides pension benefits to all full-time employees upon commencement of employment with any of the various government agencies covered by SBRS. The Commonwealth is a non-employer contributor and is only responsible for the actual cost of pension benefits for SBRS participants who serve in the City of Boston's School Department in a teaching capacity (BTRS). The cost of pension benefits of the other participants is the responsibility of the City of Boston. SBRS is not administered by the Commonwealth and is not part of the reporting entity and a stand-alone financial report is not available.

Certain Commonwealth employees and current retirees employed prior to the establishment of the State Employees' Retirement System are covered on a "pay-as-you-go" basis. During the year ended June 30, 2004, the Commonwealth's pension expenditure included payments totaling \$14,567,000 to current retirees employed prior to the establishment of the current plans and the non-contributory plans.

The policy for post-retirement benefit increases for all retirees of the SERS, TRS, BTRS and COLA of local governments is subject to legislative approval.

Membership – Membership in SERS, TRS and BTRS as of January 1, 2004, the date of the most recent valuation, is as follows:

	<u>SERS</u>	<u>TRS</u>	<u>BTRS</u>
Retirees and beneficiaries			
currently receiving benefits.....	51,418	39,341	2,992
Terminated employees entitled to			
benefits but not yet receiving them.....	2,966	N/A	169
Subtotal.....	54,384	39,341	3,161
Current employees:			
Vested*.....	41,229	43,978	3,432
Non-vested*.....	38,893	43,956	2,523
Subtotal.....	80,122	87,934	5,955
Total.....	134,506	127,275	9,116

\*Estimated

#### *Benefit Provisions*

Massachusetts General Laws establish uniform benefit and contribution requirements for all contributory PERS. These requirements provide for retirement allowance benefits up to a maximum of 80% of a member's highest three-year average annual rate of regular compensation. Benefit payments are based upon a member's age, length of creditable service, and group creditable service, and group classification. The authority for amending these provisions is with the Legislature.

Members become vested after ten years of creditable service. A superannuation retirement allowance may be received upon the completion of twenty years of service or upon reaching the age of 55 with ten years of service. Normal retirement for most employees occurs at age 65; for certain hazardous duty and public safety positions, normal retirement is at age 55.

#### *Funding Progress*

During FY01, the Legislature passed Chapter 114 of the Acts of 2000, which modified Chapter 32 of the General Laws. This modification became effective on July 1, 2001. In Chapter 114, teachers who are members of the State Teachers Retirement System, or teachers who are members of the State – Boston Retirement System before 1975, who resigned or took an unpaid leave of absence because of maternity leave will be allowed to “buy back” into the fund up to a maximum of four years. The member must pay the amount determined by the Retirement Board by December 31, 2001 to qualify, as long as the member has worked longer than ten years. If the member completes ten years of service after December 31, 2001, payment can be made within 18 months of completion of ten years of service. In addition, the law creates a superannuation retirement benefit program for all teachers hired on or after July 1, 2001. This program has a contribution rate of 11 percent of regular compensation. To be

eligible for the alternative benefit at retirement, the teacher must have completed thirty years of eligible service. All previous members may elect to participate in the program, as long as they participate with the equivalent of a minimum of five years of employee contributions at the new rate. If the member retires before five years, the teacher must pay into the system, the amount that would have been paid in one lump sum, or in installments as the Board may prescribe. The alternative benefit is calculated as the percentage of average compensation determined under the current formula increased by 2% of the average annual compensation for each full year of service in excess of 24 years. The election to participate is irrevocable.

The following table presents the schedule of funding progress as presented in the most recent actuarial valuations at the dates indicated (amounts in thousands):

Actuarial Valuation as of January 1	Actuarial Value of Plan Assets	Actuarial Accrued Liability	Unfunded Actuarial Liability (UAL)	Funded Ratio %	Annual Covered Payroll *	UAL as a % of Covered Payroll
State Employees' Retirement System						
2004	\$ 15,931,000	\$ 18,966,000	\$ 3,065,000	84.0 %	\$ 3,842,000	79.8 %
2003	13,947,000	17,551,000	3,604,000	79.5	3,779,000	95.4
2002	15,002,000	15,961,000	959,000	94.0	4,034,000	23.8
2001	13,922,000	15,170,000	1,248,000	91.8	3,700,000	33.7
2000	13,364,000	14,138,000	773,000	94.5	3,472,000	22.3
1998	9,914,000	11,361,000	1,447,000	87.3	3,111,000	46.5
1996	7,366,000	9,441,000	2,075,000	78.0	2,989,000	69.4
1995	5,879,000	8,602,000	2,723,000	68.3	2,992,000	91.0
1993	5,071,000	8,738,000	3,667,000	58.0	2,919,000	125.6
Teachers' Retirement System						
2004	17,075,000	24,519,000	7,444,000	69.6	4,556,000	163.4
2003	14,762,000	22,892,000	8,129,000	64.5	4,406,000	184.5
2002	15,712,000	20,620,000	4,908,000	76.2	4,264,000	115.1
2001	14,390,000	18,170,000	3,779,000	79.2	4,072,000	92.8
2000	13,681,000	16,420,000	2,739,000	83.3	3,704,000	73.9
1998	10,170,000	13,095,000	2,925,000	77.7	3,175,000	92.1
1996	7,553,000	10,252,000	2,699,000	73.7	2,810,000	96.0
1995	6,014,000	9,712,000	3,698,000	61.9	2,667,000	138.7
1993	5,142,000	8,921,000	3,779,000	57.6	2,428,000	155.6
State - Boston Retirement System ( Boston Teachers)						
2004	1,040,000	2,022,000	982,000	51.4	368,000	266.8
2003	919,000	1,918,000	998,000	47.9	387,000	257.9
2002	984,000	1,756,000	772,000	56.0	370,000	208.6
2001	918,000	1,502,000	583,000	61.1	304,000	191.8
2000	860,000	1,381,000	521,000	62.3	285,000	182.8
1998	699,000	1,219,000	520,000	57.3	285,000	182.5
1996	549,000	1,025,000	476,000	53.6	274,000	173.7
1995	438,000	833,000	395,000	52.6	232,000	170.3
1993	370,000	743,000	373,000	49.8	206,000	181.1

\* - The covered payroll amounts approximate the employer payroll.

### *Pension Actuarial Valuation*

The Commonwealth's pension actuarial valuation was performed as of January 1, 2004 pursuant to Chapter 32 of the General Laws of the Commonwealth of Massachusetts and based on the plan provisions at that time. The following are the most significant assumptions used in preparing the 2004 actuarial valuation:

Investment return.....	8.25% per year
Interest rate credited to annuity savings.....	3.5% per year
Cost of living increases.....	3% per year
Mortality.....	RP-2000 Health Annuitant table projected with scale AA (gender distinct). This is applicable to both pre-retirement and post-retirement benefits. Adjustments made for disabled members and certain other groups.
Salary Increases.....	Based on analysis of past experience - ranges from 4.75% to 8.5% for groups 1 and 2, 5.5% to 9.5% for group 3, 5.5% to 12% for group 4 and 4.75% to 9.5% for teachers.

### *Contributions Required and Contributions Made*

The total contributions required for SERS, TRS and SBRS are based on the entry age normal cost method using the same actuarial assumptions used to compute the net pension obligation.

The Commonwealth was financially responsible for the COLA granted to participants in the 104 retirement systems of cities, towns and counties in fiscal year 1981 to 1996. Chapter 17 of the Acts of 1997 effective for fiscal year 1998 transferred the responsibility for funding COLAs for separate (non-teacher) retirement systems of cities and towns to the respective system. Any future COLA granted by the Legislature to employees of these plans will be the responsibility of the individual system. The individual employer governments are also responsible for the basic pension benefits. The retirement systems are not administered by the Commonwealth and are not part of the reporting entity. The actuarial accrued liability for COLA as of January 1, 2004 was \$522,000,000.

The retirement systems' funding policies have been established by Chapter 32 of the Massachusetts General Laws. The Legislature has the authority to amend these policies. The annuity portion of the SERS, TRS and BTRS retirement allowance is funded by employees, who contribute a percentage of their regular compensation. Costs of administering the plan are funded out of plan assets.

Member contributions vary depending on the most recent date of membership:

<u>Hire Date</u>	<u>% of Compensation</u>
Prior to 1975.....	5% of regular compensation
1975 - 1983.....	7% of regular compensation
1984 to 6/30/1996.....	8% of regular compensation
7/1/1996 to present.....	9% of regular compensation except for State Police which is 12% of regular compensation
7/1/2001 to present.....	11% of regular compensation (for teachers hired after 7/1/01 and those accepting provisions of Chapter 114 of the Acts of 2000)
1979 to present.....	An additional 2% of regular compensation in excess of \$30,000

The Commonwealth's contribution for the pension benefit portion of the retirement allowance of SERS and TRS and required payments to cover BTRS and COLA contributions were originally established on a "pay-as-you-go" basis. As a result, amounts were appropriated each year to pay current benefits, without a systematic provision to fully fund future liabilities already incurred. Beginning in fiscal year 1988, the Commonwealth enacted the Pension Reform Act of 1987 and addressed the unfunded liability of SERS, TRS and its participation in SBRS and its COLA obligation.

This legislation also directed the Secretary of Administration and Finance to prepare a funding schedule to meet these requirements, and to update this funding schedule every three years on the basis of new actuarial valuation reports prepared under the Secretary's direction. Any such schedule is subject to legislative approval. If a schedule is not so approved, payments are to be made in accordance with the most recently approved schedule. Under the current schedule adopted in 2004, the amortization payments are designed to eliminate the unfunded liability by fiscal year 2023 on a 4.50% increasing basis. Contributions by the Commonwealth of \$687,335,000 were made during the fiscal year ended June 30, 2004. Of this amount \$71,198,000 represents payments for COLA granted to participants in retirement systems of cities, towns and counties. The Commonwealth schedule encompasses SERS, TRS and Boston Teachers.

GAAP requires that pension expenditures (costs) be based on an acceptable actuarial cost method and that they be not less than:

- Normal cost plus amortization of net pension obligation cost
- Interest and amortization on any unfunded prior service costs

The funding schedule discussed above follows an acceptable actuarial funding methodology to compute normal cost and the unfunded accrued actuarial liability.

The following table presents the schedule of employer contributions (amounts in thousands):

Actuarial Valuation as of January 1	Annual Required Contribution (ARC)	Interest on NPO	Amortization of NPO	Pension Cost	Actual Contribution Made	Net Pension (Obligation) Asset (NPO)	% of ARC Contributed	% of Pension Cost Contributed
State Employees' Retirement System								
2004	\$ 349,557	\$ (109,346)	\$ (90,749)	\$ 330,960	\$ 246,754	\$ 1,241,195	71 %	75 %
2003	397,698	(117,299)	(96,940)	377,338	280,929	1,325,401	71	74
2002	215,795	(111,506)	(92,152)	196,441	266,660	1,421,811	124	136
2001	275,204	(109,731)	(133,387)	298,861	320,381	1,351,592	116	107
2000	352,084	(108,400)	107,190	350,873	367,000	1,330,071	104	105
1999	319,454	(103,188)	98,556	314,822	378,000	1,313,944	118	120
1998	261,255	(83,446)	77,180	254,989	494,289	1,250,766	189	194
1997	246,037	(65,478)	41,889	222,448	463,590	1,011,466	188	208
1996	232,158	(46,918)	29,523	214,763	433,114	770,324	187	202
1995	249,640	(31,639)	19,614	237,615	417,361	551,973	167	176
Teachers' Retirement System								
2004	610,841	(65,373)	(54,225)	599,722	359,476	552,153	59	60
2003	651,021	(83,468)	(68,980)	636,534	417,204	792,400	64	66
2002	411,225	(82,377)	(68,079)	396,927	410,143	1,011,729	100	103
2001	475,053	(78,498)	(95,421)	491,976	539,000	998,513	113	110
2000	480,873	(79,487)	78,599	479,985	468,000	951,489	97	98
1999	373,777	(70,312)	67,155	370,620	481,826	963,474	129	130
1998	315,474	(59,126)	54,686	311,034	446,619	852,267	142	144
1997	245,426	(44,832)	28,681	229,275	418,519	716,682	171	183
1996	232,403	(30,311)	19,073	221,165	392,003	527,439	169	177
1995	277,343	(24,002)	14,880	268,221	342,441	356,601	123	128
Boston Teachers Retirement System								
2004	74,787	5,374	4,460	75,701	45,364	(95,480)	61	60
2003	76,151	3,411	2,819	76,743	52,944	(65,142)	70	69
2002	94,003	(67)	(56)	93,992	51,833	(41,343)	55	55
2001	66,820	1,542	1,875	66,488	86,000	815	129	129
2000	58,266	448	(443)	58,271	45,000	(18,697)	77	77
1999	53,453	(989)	944	53,409	36,000	(5,426)	67	67
1998	48,795	(2,114)	1,995	48,636	35,000	11,983	72	72
1997	34,621	(2,082)	1,332	33,871	35,000	25,619	101	103
1996	32,908	(1,860)	1,171	32,219	34,822	24,490	106	108
1995	28,168	(1,816)	1,126	27,478	28,000	21,887	99	102

The total contributions required for SERS, TRS and SBRS are based on the entry age normal cost method using the same actuarial assumptions used to compute the net pension obligation.

*Change in Budgetary Funding for Pensions and Transfer of Assets*

The FY04 GAA amended the General Laws to allow annual pension appropriations to be paid at an amount equal to the scheduled amount less the value of any capital assets transferred to the pension liability fund. The FY04 GAA funded the \$832.3 million pension obligation using \$687.3 million in cash from the General Fund and the transfer to the pension liability fund of the Commonwealth from the Massachusetts Convention Center Authority the Hynes Convention Center and the Boston Common Garage. The legislation authorizing the transfer valued the asset at \$145 million. Subsequent to year-end, the FY05 GAA created a commission to study the reuse or disposition of the assets, calling into question the transfer of the asset itself. The new pension funding schedule submitted during FY04 assumes that the asset does not transfer to the pension liability fund. The commission is to report its findings and any proposed legislation needed, delivering its report no later than December 31, 2005. Due to the uncertainty of this transfer, the Commonwealth's pension funds have not recorded a receivable for these transfers.

In addition, the FY05 GAA also added certain other pension payments to be funded "off-budget." These payments to veterans and other groups paid pursuant to various acts passed in the 1980's totaled approximately \$14.6 million in FY04 and are expected to total a similar amount in FY05.

*Post-retirement Health Care and Life Insurance Benefits*

In addition to providing pension benefits, under Chapter 32A of the Massachusetts General Laws, the Commonwealth is required to provide certain health care and life insurance benefits for retired employees of the Commonwealth, housing authorities, redevelopment authorities, and certain other governmental agencies. Substantially all of the Commonwealth's employees may become eligible for these benefits if they reach retirement age while working for the Commonwealth. Eligible retirees are required to contribute a specified percentage of the health care benefit costs which is comparable to contributions required from employees. The Commonwealth is reimbursed for the cost of benefits to retirees of the eligible authorities and non-state agencies. The Commonwealth recognizes its share of the costs of providing these benefits when paid. These payments totaled approximately \$273,828,000 for the fiscal year ended June 30, 2004. There are approximately 53,847 participants eligible to receive benefits at June 30, 2004.

The Commonwealth has not performed an actuarial valuation of its post-retirement health care and life insurance benefit liability. Private industry typically sees an actuarial accrued liability of 10 to 20 times the current annual payments. For the Commonwealth, this would extrapolate to an actuarial accrued liability of \$2.5 billion to \$5 billion.

The FY04 General Appropriation Act changed the employee contribution rates for group health insurance, with the exception of current employees earning less than \$35,000 and retirees. Current employees as of July 1, 2003 will contribute 20% to their health insurance costs if they earn over \$35,000. New employees will contribute 25%. In fiscal 2006, the contribution rates will return to 15% for all employees.

## 11. LEASES

### Primary Government

In order to finance the acquisition of equipment, the Commonwealth has entered into various lease/purchase agreements, including tax-exempt lease purchase (TELP) agreements, which are accounted for as capital leases. Lease agreements are for various terms and contain clauses indicating that their continuation is subject to appropriation by the Legislature.

The Commonwealth has numerous operating lease agreements for real property and equipment with varying terms. These agreements contain provisions indicating that continuation is subject to appropriation by the Legislature.

The Colleges and the University lease real property and equipment under numerous operating lease agreements for varying terms.

The following schedule summarizes future minimum payments under non-cancelable leases for governmental activities and for the Colleges and University – reported as a business-type activity, for the fiscal year ended June 30, 2004 (amounts in thousands):

Fiscal Year Ended June 30	Governmental Activities				Business - Type Activities			
	Capital Leases		Operating Leases	Governmental Activities Total	Capital Leases		Operating Leases	Business -Type Activities Total
	Principal	Interest			Principal	Interest		
2005 .....	\$ 19,185	\$ 2,950	\$ 153,888	\$ 176,023	\$ 15,852	\$ 3,158	\$ 14,472	\$ 33,482
2006 .....	15,027	2,311	98,929	116,267	14,472	2,341	11,534	28,347
2007 .....	10,161	1,563	72,792	84,516	12,763	1,712	10,328	24,803
2008 .....	9,080	1,396	43,710	54,186	11,952	1,168	9,798	22,918
2009 .....	1,134	174	27,805	29,113	6,158	712	9,309	16,179
2010 - 2014 .....	3,313	510	98,746	102,569	12,348	779	17,535	30,662
2015 - 2019 .....	-	-	45,982	45,982	426	-	1,274	1,700
2020 - 2024 .....	-	-	45,982	45,982	-	-	-	-
2024 - 2028 .....	-	-	45,982	45,982	-	-	-	-
2029 - 2033 .....	-	-	36,786	36,786	-	-	-	-
Total lease obligations.....	57,900	8,904	670,602	737,406	73,971	9,870	74,250	158,091
Less: current portion: .....	(19,185)	(2,950)	(153,888)	(176,023)	(15,852)	(3,158)	(14,472)	(33,482)
Long - term lease obligations .....	<u>\$ 38,715</u>	<u>\$ 5,954</u>	<u>\$ 516,714</u>	<u>\$ 561,383</u>	<u>\$ 58,119</u>	<u>\$ 6,712</u>	<u>\$ 59,778</u>	<u>\$ 124,609</u>



*Discretely Presented Component Units –*

The following is a schedule by years of future minimum lease payments under capital leases together with the present value of net minimum lease payments as of June 30, 2004 (amounts in thousands):

Fiscal Year Ended <u>June 30</u>	Massachusetts Bay Transportation <u>Authority</u>	Nonmajor <u>Component Units</u>	<u>Total</u>
2005 .....	\$ 41,403	\$ 831	\$ 42,234
2006 .....	42,448	875	43,323
2007 .....	47,901	744	48,645
2008 .....	52,985	4	52,989
2009 .....	47,441	-	47,441
2010 - 2014 .....	349,147	-	349,147
2015 - 2019 .....	<u>186,939</u>	<u>-</u>	<u>186,939</u>
Lease obligations .....	768,264	2,454	770,718
Less: Interest portion: .....	<u>(230,166)</u>	<u>(195)</u>	(230,361)
Present value of minimum lease payments .....	538,098	2,259	540,357
Less: current portion .....	(10,867)	(642)	(11,509)
Long - term lease obligations .....	\$ 527,231	\$ 1,617	\$ 528,848

The MBTA has entered into several sale-leaseback agreements with major financial institutions, covering equipment and rolling stock, which has been accounted for as operating leases. These leases expire through fiscal year 2013. Upon termination, the MBTA may purchase the equipment and rolling stock at prices equal to the lesser of a stated percentage (40% -70%) of the lessor's original purchase price or residual fair market value, as defined.

The MTA has operating leases for administrative office space and automatic toll collection equipment. These operating leases expire on various dates through June 2005. Lease expenses charged to the Massachusetts Turnpike and Sumner-Callahan-Williams Tunnels were approximately \$953,000 of which \$854,000 was paid to the Commonwealth for office space in a state-owned building.

The MTA leases property and air rights to others. The MTA earned approximately \$29,800,000 in rental income of which \$18,100,000 was received for restaurant, concessions and service station rentals.

The future minimum rental payments required under operating leases having initial or remaining non-cancelable lease terms in excess of one year are as follows (as of December 31, 2003 for the MTA) (amounts in thousands):

Fiscal Year Ended <u>June 30</u>	Massachusetts Bay Transportation Authority	Massachusetts Turnpike Authority	Nonmajor Component Units	Total
2005 .....	\$ 13,046	\$ 869	\$ 1,245	\$ 15,160
2006 .....	13,312	437	1,300	15,049
2007 .....	13,681	-	1,054	14,735
2008 .....	13,652	-	989	14,641
2009 .....	13,461	-	998	14,459
2010 - 2014 .....	43,868	-	1,259	45,127
2015 - 2019 .....	-	-	1,213	1,213
2020 - 2024 .....	-	-	115	115
2025 - 2029 .....	-	-	63	63
Total lease obligations .....	<u>\$ 111,020</u>	<u>\$ 1,306</u>	<u>\$ 8,236</u>	<u>\$ 120,562</u>

## 12. COMMITMENTS

### A. *Commitments to Discretely Presented Component Units and Other Entities*

The Commonwealth is obligated to dedicate a sales tax amounting to 1% of applicable sales in the Commonwealth, directly to the MBTA to fund its operations. The dedicated sales tax equals to the greater of the amount raised by the sales tax or a defined base revenue amount, subject to an adjustment for inflation, capped at 3% annually. For FY04, the base revenue is approximately \$704,809,000.

The Commonwealth continues to guarantee certain Massachusetts Bay Transportation Authority (MBTA) debt outstanding at June 30, 2004, totaling \$2,278,390,000. Debt issued by the MBTA subsequent to the passage of the forward funding legislation is no longer guaranteed by the fullfaith and credit of the Commonwealth.

At June 30, 2004, the Commonwealth had commitments of approximately \$862,829,000 related to ongoing construction projects. The majority relate to construction funding for the Central Artery/Tunnel Project. The Central Artery/Tunnel Project continues to anticipate federal participation and payments from the Massachusetts Turnpike Authority (MTA) and the Massachusetts Port Authority (MassPort).

In addition to the residual obligations of the MBTA, the Commonwealth guarantees debt of a number of Public Authorities. At June 30, 2004, the aggregate outstanding debt for which the Commonwealth is obligated to provide contract assistance support totaled approximately \$1,597,957,000, of which \$693,885,000 is for the Route 3 North Transportation Improvements Association and \$655,890,000 is for the University of Massachusetts Building Authority.

Under Chapter 161B of the General Laws, the Commonwealth is obligated to provide annual subsidies to certain regional transit authorities for contract assistance, debt service assistance and their net cost of service deficiencies. The FY04 General Appropriation Act amended Chapter 161B. Based on those amendments subsequent to July 1, 2003, bonds and notes issued by the various authorities are no longer guaranteed by the Commonwealth and are not general obligations of the Commonwealth.

**B. *Saltonstall Building***

The Massachusetts Development Finance Agency (MDFA) was authorized in legislation to undertake redevelopment of the Saltonstall State Office Building and its surrounding area. Under the provisions of MDFA's bond authorization, the building is to be leased by the MDFA for a lease term of up to 50 years with extension terms permitted for an aggregate 30 more years. The MDFA renovated the building and leases half of it back to the Commonwealth for office space and related parking for a comparable lease term. The remainder of the building and surrounding area has been redeveloped as private office space, housing and retail establishments. The Commonwealth is obligated for future lease payments for space it rents. However, this obligation is not a general obligation or a pledge of credit of the Commonwealth. Though MDFA's bonds are revenue obligations, with pledges of the public and private lease payments, the Commonwealth's lease payments are subject to annual appropriation.

**C. *Central Artery / Tunnel Project***

The Central Artery / Tunnel Project is the largest single component of the Commonwealth's capital program according to the projects finance plan filed as of October 1, 2004. The current cost estimate is \$14.625 billion. The plan includes a maximum obligation of \$8.549 billion from the federal government.

**D. *Pension Trust Funds***

At June 30, 2004, PRIT had outstanding commitments to invest approximately \$1,655,000,000 in alternative investments and \$68,000,000 in distressed debt. The fair value of the proposed investment commitments approximates their stated value.

**E. *Commitments of Discretely Presented Component Units***

Chapter 152 of the Acts of 1997 provides \$609,400,000 for the construction of a Convention and Exhibition Center that will provide 600,000 square feet of exhibit space at a site in South Boston. The Boston Redevelopment Authority (BRA) is authorized and directed by the legislation to acquire the land, properties, and rights related to the proposed construction site. Once this is accomplished, the Massachusetts Convention Center Authority (MCCA) will oversee construction of the new facility. The MCCA will operate the new center and the Springfield Civic Center, along with the Hynes Convention Center and the Boston Common Garage on behalf of PRIT, if the facilities transfer is completed.

As of June 30, 2004, the Massachusetts Water Pollution Abatement Trust (MWPAT) has agreed to provide loans of \$28,000,000 to various local government units to be funded with grant awards.

The MTA entered into construction contracts for the Metropolitan Highway system and the Western Turnpike with various construction and engineering companies. Construction contracts outstanding at December 31, 2003 approximated \$14,000,000.

**F. *Boston Housing  
Authority West  
Broadway Homes  
Project***

In FY04, the Boston Housing Authority (BHA) issued \$10 million of housing project bonds to finance a portion of the costs of construction of a lower income public housing project in South Boston. A captive non-profit corporation of the BHA will own and operate the project. The Commonwealth has agreed in the form of contract assistance to subsidize these bonds as part of other subsidies provided to the BHA for its normal operations, subject to appropriation. A portion of the bonds may be redeemed by advance additional grant funds to the BHA on December 1, 2006, to the extent the project has failed to demonstrate budgeted revenue sufficiency by that date. Thereafter, the bonds will be secured by and payable solely from an assignment of Commonwealth operating subsidy fund to the BHA allocable to the project as well as other funds available to the BHA.

### **13. CONTINGENCIES**

***Primary Government -***

Governmental Funds – The General Fund services claims for all risks of loss for which the Commonwealth is exposed, other than workers' compensation and employee group health and life insurance, which are managed in its general operations. A number of lawsuits are pending or threatened against the Commonwealth which arose from the ordinary course of operations. These include claims for property damage and personal injury, breaches of contract, condemnation proceedings and other alleged violations of law. For cases in which it is probable that a loss will be incurred and the amount of the potential judgment can be reasonably estimated, or a settlement or judgment has been reached but not paid, the Attorney General estimates the liability to be approximately \$6,650,000 as of June 30, 2004. The General Fund allocates the cost of providing claims servicing and claims payment by charging a premium to each fund based on claims paid during the year.

The Commonwealth receives significant financial assistance from the federal government. Entitlement to these resources is generally conditional upon compliance with terms and conditions of the grant or reimbursement agreements and with applicable federal regulations, including the expenditure of the resources for eligible purposes. Substantially all federal financial assistance is subject to financial and compliance audits. Any disallowances become liabilities of the fund that received the assistance. As of June 30, 2004, the Commonwealth estimates that liabilities, if any, which may result from such audits are not material.

The Commonwealth's abandoned property law requires deposit of certain unclaimed assets into a managed Fiduciary Fund. These unclaimed assets, less \$6,907,000 that is expected to be reclaimed and paid in fiscal year 2004, are to be remitted to the General Fund each June 30, where it is included as a transfer. Amounts remitted during fiscal year 2003 totaled approximately \$103,803,000. Since inception, approximately \$1,160,167,000 has been remitted. This represents a contingency, because claims for refunds can be made by the owners of the property.

**A. Tobacco Settlement**

A Master Settlement Agreement (MSA) was executed in November of 1998 between five tobacco companies and 46 states, including the Commonwealth. The MSA called for, among other things, annual payments to the states in perpetuity. These payments have been estimated to total more than \$200 billion over the first 25 years, subject to various offsets, reductions, and adjustments.

In FY04, the Commonwealth received approximately \$253,621,000 or 90% of the estimated amounts shown in the MSA. All received amounts were transferred to the General Fund.

On December 19, 2003, a Suffolk Superior Court jury rejected the claims of the Commonwealth's private tobacco attorneys that they should be paid a fee amounting to 25% of the Commonwealth's tobacco settlement money. The jury awarded the plaintiffs 10.5% of the amount the Commonwealth receives under the Master Settlement Agreement through 2025. To date, however, the attorneys have received more than 10.5% of what the Commonwealth has received under the MSA. Whether the Commonwealth will in the future be required to pay any sum on private counsel's claim will depend on the actual payments received by the Commonwealth under the MSA through 2025, as well as on the amounts the attorneys receive through the arbitration payments.

**B. Unemployment Compensation Fund**

During FY04, the Commonwealth received loans from the federal government to fund the unemployment compensation operating deficit, the fund balance declined by \$368.2 million. All of these borrowings were paid back in May 2004. No additional revenues were needed to be collected from employers in order to pay accrued interest as the loans were interest free. The fund balance in the Unemployment Compensation Fund stands at approximately \$122.5 million as of June 30, 2004. On October 13, 2004, the Commissioner of the Division of Unemployment Assistance announced that further loans will be needed in FY05 to pay unemployment benefits.

**C. Workers' Compensation and Group Insurance Liabilities**

Workers' Compensation is managed as part of the course of the Commonwealth's general operations. No separate fund for workers' compensation is provided for in Massachusetts General Laws. Claims for compensation are not separately insured and are funded by the Commonwealth only when incurred. Such losses, including estimates of amounts incurred, but not reported are included as accrued liabilities in the accompanying financial statements when the loss is incurred. The Commonwealth assumes the full risk of claims filed under a program managed by the Human Resources Division. For personal injury, Massachusetts General Laws limit the risk assumed by the Commonwealth to \$100,000 per occurrence, in most circumstances.

Based on actuarial calculations as of June 30 2004, discounted at 4%, the Commonwealth is liable for unfunded claims and incurred but not reported claims totaling \$302.2 million, which is reported in accrued liabilities in the Governmental Activities.

Changes in the Commonwealth's liability relating to workers' compensation claims in FY04 were (amounts in millions):

Claim liability, beginning of year.....	\$ 275.7
Increase in liability estimate.....	77.8
Payments and decreases in liability estimate.....	<u>51.3</u>
Claims liability, end of year.....	<u>\$ 302.2</u>

The Group Insurance Commission (GIC), a department of the Commonwealth, manages health insurance claims of the Commonwealth's active and retired employees. The Commonwealth is self-insured and various health insurance providers provide health care services to the employees. The accrued liability is estimated based on data provided to the GIC by the insurance companies who participate in the self-insured plans.

Based on GIC estimates, the Commonwealth is liable for an amount of \$37.4 million. Changes in the Commonwealth's liability relating to Group Insurance claims in FY04 were (in million):

Claim liability, beginning of year.....	\$ 47.0
Increase in liability estimate.....	778.0
Payments and decreases in liability estimate.....	<u>787.6</u>
Claims liability, end of year.....	<u>\$ 37.4</u>

**D. Central  
Artery/Tunnel  
Project**

*Owner Controlled Insurance Program (OCIP)*

The Commonwealth of Massachusetts has assumed responsibility for providing worker's compensation and general liability insurance for all eligible contractors and subcontractors working on the Central Artery/Tunnel Project by establishing an Owner Controlled Insurance. The Highway Department established a trust managed and administered by an independent third party (trustee) to protect a portion of the assets set aside with the insurance carrier to fund project liabilities.

The amounts in the Trust are restricted by its terms and cannot be used for other purposes. The withdrawals, other than those to cover costs specified by the Trust Agreement, require mutual consent. During FY03 federally funded fund assets were replaced by state assets and therefore are no longer restricted as to the ultimate distribution at the end of the Project.

The Project's OCIP activity is reported as a minor governmental (capital project) fund. The "Claims and Judgements" liabilities reported within the fund represents the Project's liabilities as estimated by an independent actuary for incurred losses projected to their ultimate value as of the end of the fiscal year for FY03. The remaining liability is reported as part of the non-current liability in the statement of net assets.

As of June 30, 2004, the OCIP has accumulated approximately \$203,071,000 in assets that consist of approximately \$144,088,000 in cash and investments, approximately \$58,043,000 in funds held by the investment provider and approximately \$1,000,000 in interest income receivable. Net assets at year – end of approximately \$76,313,000 were restricted for workers' compensation and general liability claims.

The OCIP's assets are to be available to pay the obligations under the programs. These insurance programs are presently structured as retrospectively rated insurance programs with retained loss limits of \$1,000,000 per claim, \$3,000,000 per occurrence for worker's compensation and \$2,000,000 per enrolled contractor or other named insureds, \$6,000,000 per occurrence for general liability coverage. The Commonwealth is responsible for loss costs up to these amounts.

The estimated Claims and Judgements liability for the OCIP for occurrences through June 30, 2004 is \$113,800,000, of which \$31,100,000 is presented as a current liability in the minor governmental fund, while the remaining \$82,700,000 is presented on the statement of net assets. This amount is based on the results of a review performed by an independent actuarial firm retained by the Project, and it represents an estimate of liabilities incurred based on past experience for claims reported and not reported as of June 30, 2004.

#### *Central Artery / Tunnel Project Leaks*

In September 2004, a leak was discovered in the I-93 tunnel. Subsequent to this, the existence of other leaks in the Central Artery / Tunnel Project have been identified. The Massachusetts Turnpike Authority and project management have asserted that the independent engineer retained by the Project has examined this issue and the Turnpike Authority believes that correcting those conditions is within the scope of existing contracts and will not result in significant additional costs for either the Turnpike Authority or the Commonwealth. At this time, the Commonwealth has not independently assessed the extent of the leaks or to what extent a liability, if any for these repairs, would accrue to the Commonwealth.

**E. Claims and Judgments**

The following amounts were recognized as of June 30, 2004 (amounts in thousands):

	Balance as of July 1, 2003	Additions	Reductions	Balance as of June 30, 2004
Short-term.....	\$ 84,696	\$ 13,539	\$ 60,485	\$ 37,750
Long-term.....	75,700	7,000	-	82,700
	<u>\$ 160,396</u>	<u>\$ 20,539</u>	<u>\$ 60,485</u>	<u>\$ 120,450</u>

**F. Discretely Presented Component Units**

The MBTA reserves self-insurance liabilities as claims and judgements as of June 30, 2004. Changes in the self-insurance reserves in fiscal 2004 and 2003 were as follows (amounts in thousands):

	2004	2003
Liability, beginning of year.....	\$ 88,837	\$ 86,644
Current year claims and changes in estimates.....	128,281	103,949
Claims payments.....	<u>(128,012)</u>	<u>(101,756)</u>
Liability, end of year.....	<u>\$ 89,106</u>	<u>\$ 88,837</u>